Global Procurement Excellence

A Quantitative Way to Determine PSM Best Practices

EIPM Annual Conference
Geneva, Dezember 8, 2006
Starting point for our research

Imagine you are …

… a general manager promoted to a CPO role

… a CEO wanting to give guidance to his procurement organization

… a purchasing professional asked to revamp a local procurement organization

… a CPO changing industries

This is what you will hear …

Global sourcing is a must!

Training, coaching apprenticeship!

Supplier development has high impact

Benchmarking is the key to good prices

Data transparency is key: Business data warehouse, SAP, Oracle …

Tools create results – e-Procurement the solution

Source: McKinsey
Main questions we wanted to answer (quantitatively!!)

- How much differentiating is good procurement really?
- And what makes up good procurement? What really makes the difference?
- What is the payback from the management investment?

Expect some surprising answers…

Source: PSM Best Practice Team of McKinsey and SMI
Contents

Survey approach

General conclusions and insights
Our insights are based on a large-scale, empirical study focused on correlating PSM* practices with performance

- More than 200 participating companies, from all geographies and major industry sectors; 70% with > 5 USD billions in revenue
- Comprehensive survey, based on experience from 1000+ McKinsey procurement engagements over the last 5 years
- Conducted in collaboration with Supply Management Institute (SMI) of European Business School
- Results statistically correlated and validated confidence level >95%

* Purchasing and Supply Management
Source: PSM Best Practice Team of McKinsey and SMI
The empirical survey is based on the "Health to Performance" framework of McKinsey's Global PSM Practice

PSM health

Business strategy alignment and contribution
“PSM alignment and support of business strategy”

PSM performance

"Contribution to company success relative to cost, revenues, quality and execution speed"

Capabilities & Culture
"The way PSM professionals think, feel, and conduct themselves in the workplace, individually and collectively"

Category management and execution
"What PSM strategies and processes the company follows to create value"

Structure & Systems
"How the resources of the PSM function are managed through formal structures and how the function interacts with other company functions"

Source: PSM Best Practice Team of McKinsey and SMI
The “Health to Performance” framework differentiates 11 drivers

<table>
<thead>
<tr>
<th>Drivers</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Business strategy alignment and contribution</td>
<td>• Strategies and practices to contribute to larger strategic goals of the company</td>
</tr>
<tr>
<td>• Mindsets and aspirations</td>
<td>• View of PSM’s role and aspirations across internal stakeholders</td>
</tr>
<tr>
<td>• Capabilities of PSM professionals</td>
<td>• Practices of recruiting, training, and developing PSM professionals</td>
</tr>
<tr>
<td>• Strategic sourcing</td>
<td>• Category strategies and internal category management processes</td>
</tr>
<tr>
<td>• Supply base strategy</td>
<td>• Supplier segmentation strategies and supply base mgmt.</td>
</tr>
<tr>
<td>• Value chain management</td>
<td>• Strategies to optimize value creation from existing suppliers</td>
</tr>
<tr>
<td>• Performance management</td>
<td>• Translation of PSM aspirations into a measurable target hierarchy and tracking of performance against it</td>
</tr>
<tr>
<td>• PSM roles and responsibilities</td>
<td>• Global coordination of strategic and transactional PSM activities</td>
</tr>
<tr>
<td>• Cross-functional collaboration</td>
<td>• Organizational setup of cross-functional collaboration and PSM’s role in it</td>
</tr>
<tr>
<td>• Knowledge and information management</td>
<td>• Systems supporting data evaluation, e-PSM and knowledge sharing</td>
</tr>
<tr>
<td>• Influence and reach</td>
<td>• Tools and activities to track, manage and influence demand and compliance</td>
</tr>
</tbody>
</table>

Each driver is explored through 3-4 detailed questions

Source: PSM Best Practice Team of McKinsey and SMI
The empirical survey follows a structured process to collect and analyze data and to feedback results to participants.

**Structured interview**

1. Neither formal nor professional RFx processes in place
   - Standardized RFx processes usually result in competitive offers
   - RFx processes are too general
   - RFx processes are highly standardized, stream-lined, modular to fully exploit supply market

2. RFx processes based on formal rules with category-specific exceptions
   - RFx processes overly complex
   - RFx processes are too rigid

3. Regular RFx mostly among existing suppliers
   - RFx processes are too infrequent
   - RFx processes are too informal

4. High individual work load despite standardized processes
   - RFx processes are too manual
   - RFx processes are too time-consuming

5. Necessary data available but distributed in different systems
   - RFx processes are too fragmented
   - RFx processes are too ad-hoc

Feedback to participant

Thorough data analysis

- Research collaboration with Supply Management Institute (SMI) of European Business School
- Use of statistical tools like SPSS and PLS
- Introduction of control variables to eliminate noise

Source: PSM Best Practice Team of McKinsey and SMI
Contents

Survey approach

Conclusions and insights
Our large-scale empirical survey showed that…

- **Purchasing pays**: There is a strong correlation between PSM health and financial performance
- **Even the best can improve**: While 54% of companies score at least once a 5, no participant scores 4 or higher on all performance drivers
- **Grass is not always greener**: Every industry sector has its high performers, being in a low-performing sector is not an excuse
- **The best see the journey**: Top performers chronically underrate their performance and set stretch targets – while low performers fail to see their opportunities
- **People matter most**: Capabilities and culture have the strongest impact on purchasing performance
- **Increase headcount (selectively)**: High performers invest in 50% more strategic sourcing professionals per dollar of spend and realize significantly more savings
- **Earn a seat at the table…**: CPOs of high performers are 5 times as often part of the senior management team of the company than those of low performers
- **… and make the most of it**: PSM involvement in corporate strategic decisions can double PSM performance contribution
- **Take charge**: Center-lead to improve performance
- **Take charge, the sequel**: High performers are responsible for more spend than low performers – and they really control it

Source: PSM Best Practice Team of McKinsey and SMI
Purchasing pays – There is a strong correlation between PSM health and financial performance

An improvement by 1.0 average survey score ...

Average survey scores across all drivers
Scale 1 - 5

... results in higher performance

Percentage points

- Annual PSM savings
  +2.2

- Annual reduction of COGS*
  +1.1

- Average EBITDA margin
  +4.5

Average across industries

- Absolute values

- Average

- Confidence level of correlations > 99%

* Relative to revenues, i.e., controlling for product price decrease
Source: PSM Best Practice Team of McKinsey and SMI
Even the best can improve – there is room for improvement for every purchasing organization we interviewed

Share of participants
Percent

<table>
<thead>
<tr>
<th>Average survey score*</th>
<th>1.5</th>
<th>2.0</th>
<th>2.5</th>
<th>3.0</th>
<th>3.5</th>
<th>4.0</th>
<th>4.5</th>
<th>5.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent</td>
<td>6</td>
<td>9</td>
<td>21</td>
<td>33</td>
<td>24</td>
<td>6</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

* Scores range from -0.25 to +0.24, i.e., for example, from 1.75 to 2.24 for column labeled as 2.0
Source: PSM Best Practice Team of McKinsey and SMI
Grass is not always greener – every industry sector has its high performers. Being in a low-performing sector is not an excuse.

<table>
<thead>
<tr>
<th>Industries</th>
<th>Average survey score</th>
<th>Score of best company</th>
<th>Share of companies with score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automotive and assembly</td>
<td>3.25</td>
<td>4.3</td>
<td>54</td>
</tr>
<tr>
<td>High tech and telecoms</td>
<td>3.21</td>
<td>4.1</td>
<td>46</td>
</tr>
<tr>
<td>Packaged goods</td>
<td>3.16</td>
<td>4.2</td>
<td>45</td>
</tr>
<tr>
<td>Chemicals and pharma</td>
<td>2.95</td>
<td>3.7</td>
<td>42</td>
</tr>
<tr>
<td>Other*</td>
<td>2.71</td>
<td>3.6</td>
<td>15</td>
</tr>
<tr>
<td>Materials and construction</td>
<td>2.65</td>
<td>3.9</td>
<td>13</td>
</tr>
<tr>
<td>Financial institutions</td>
<td>2.45</td>
<td>4.0</td>
<td>11</td>
</tr>
<tr>
<td>Energy and utilities</td>
<td>2.42</td>
<td>3.5</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2.88</strong></td>
<td><strong>4.3</strong></td>
<td><strong>31</strong></td>
</tr>
</tbody>
</table>

* Including retail, travel and logistics, entertainment

Source: PSM Best Practice Team of McKinsey and SMI
The best see the journey – while high performers recognize they are on a journey low performers fail to see their opportunities

Low performers are overly optimistic and do not see the potential

Over estimation by 0.5

High performers are very critical in their self-assessment

Under estimation by 0.5

Source: PSM Best Practice Team of McKinsey and SMI
**People matter most – capabilities and culture have the strongest impact on purchasing performance**

<table>
<thead>
<tr>
<th>Capability</th>
<th>Share of Impact on Overall Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mindsets and aspirations</td>
<td>0.37</td>
</tr>
<tr>
<td>Capabilities of PSM professionals</td>
<td>0.20</td>
</tr>
<tr>
<td>Business strategy alignment and contribution</td>
<td>0.18</td>
</tr>
<tr>
<td>Power and reach</td>
<td>0.08</td>
</tr>
<tr>
<td>Supply base strategy</td>
<td>0.07</td>
</tr>
<tr>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1.00</strong></td>
</tr>
</tbody>
</table>

* Overall performance calculated as average of standardized PSM savings, reduction of COGS, and EBITDA margin; + 1.0 in survey score per driver allows to realize X% of performance improvement achieved by + 1.0 in overall survey score, e.g., 37% of overall performance improvement can be realized by + 1.0 in mindsets and aspirations only.

Source: PSM Best Practice Team of McKinsey and SMI
Increase headcount (selectively) – high performers invest in strategic sourcing professionals and it pays off

**Number of strategic buyers**

Per USD 1 billion spend

- Low performers: 13
- Medium performers: 21
- High performers: 19

**Annual reduction of COGS**

Percentage points

- Low performers: -0.5
- Medium performers: 0.8
- High performers: 1.4

*Example (USD 1 billion spend)*

Medium and high performers invest ~ USD 1.5 million* into more strategic buyers

Medium and high performers realize USD 15 - 20 million more savings

* Assuming USD 0.2 million costs per strategic buyer

Source: PSM Best Practice Team of McKinsey and SMI
Earn a seat at the table … – reporting level of CPO mirrors the value creation expectation of the PSM function

Percent

<table>
<thead>
<tr>
<th>Low performers</th>
<th>Medium performers</th>
<th>High performers</th>
</tr>
</thead>
<tbody>
<tr>
<td>3%</td>
<td>4%</td>
<td>3%</td>
</tr>
<tr>
<td>65%</td>
<td>70%</td>
<td>61%</td>
</tr>
<tr>
<td>23%</td>
<td>12%</td>
<td>12%</td>
</tr>
</tbody>
</table>

CPO reporting below senior management team
CPO reporting to senior management team member
CPO reporting to CEO
CPO is member of senior management team

Source: PSM Best Practice Team of McKinsey and SMI
... and make the most of it – PSM involvement in corporate strategic decision making can double PSM performance contribution

PSM performance contribution

Corporate strategic contribution

Category purchasing processes

Category value creation strategies

Cross-functional cooperation structures

Purchasing organization structure

Knowledge and information management

Talent management

Performance management

Mindsets and aspirations

People are at the root

Significant cause-and-effect relationship

* Contribution to corporate strategy development, new product development, marketing & sales strategy, M&A activities
Take charge – Center-lead your organization to improve performance

Percent

Low performers | Medium performers | High performers
---|---|---
35 | 11 | 10
38 | 34 | 21
27 | 30 | 34
0 | 25 | 35

Decentralized
Mixture of centralized and decentralized
Centralized
Lead-buyer network

Source: PSM Best Practice Team of McKinsey and SMI
Take charge, the sequel – high performers are responsible for more spend than low performers. And they really control it.

There are differences in formal PSM spend controlled …

Percent of total spend controlled*

- Low performers: 71%
- Medium performers: 77%
- High performers: 79%

... and in realized influence on spend

Survey score 'power and reach'**

- Low performers: 1.8
- Medium performers: 2.4
- High performers: 3.1

* Spend figures stem from baseline survey, i.e., are self-reported by CPOs
** Survey scores stem from interview, i.e., are rated by interviewers
Source: PSM Best Practice Team
Summary

- Purchasing pays – the quantitative data on that topic is conclusive and highly correlated: on average, low performers in purchasing and supply management lose 5 percentage points in EBITDA margin compared to high performers.

- People matter most – to improve, CPOs must move out of the “graveyard of the company” image (and manage the function accordingly). This is by far more important than systems, methods and tools.

- Centralization is good – whenever possible, take charge, both of unusual categories as well as the decision rights, and when building the organization a dominant central lead has substantial impact.

Source: PSM Best Practice Team of McKinsey and SMI
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BACKUP
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### Explanation of some basic statistical evaluations

<table>
<thead>
<tr>
<th>Conceptual drawing</th>
<th>Statistical evaluation</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Performance</strong></td>
<td><strong>Separation of low, medium, and high performers</strong></td>
<td>Cluster analysis grouping companies by their similarity in survey scores, i.e., independent of performance measures. We find high correlation to actual performance.</td>
</tr>
<tr>
<td><img src="image" alt="Performance diagram" /></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Frequency</strong></td>
<td><strong>Confidence level of evaluations</strong></td>
<td>Confidence level gives the probability that there is really a relevant relationship between variables, i.e., that results have not come by chance. Confidence level is driven by the size of the influencing effect, the distribution of the data sets, and the number of data points.</td>
</tr>
<tr>
<td><img src="image" alt="Frequency diagram" /></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: PSM Best Practice Team of McKinsey and SMI
## Definition of performance measures

<table>
<thead>
<tr>
<th>Performance measure</th>
<th>Data source</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual PSM savings</td>
<td>Baseline survey</td>
<td>Self-reported annual reduction of total landed cost, in external spend controlled by the PSM function; does not cover cost avoidance</td>
</tr>
<tr>
<td>Annual reduction of cost of goods sold (COGS)</td>
<td>Company annual reports/Bloomberg</td>
<td>Annual change of COGS after eliminating effects from revenue increase/decrease; for consistency reasons COGS calculated as revenue – EBITDA</td>
</tr>
<tr>
<td>Average EBITDA margin</td>
<td>Company annual reports/Bloomberg</td>
<td>Defined as EBITDA/total revenues (for banks: net revenues); EBITDA calculated manually to ensure consistency</td>
</tr>
</tbody>
</table>

All performance measures represent average 2002 - 04

Source: PSM Best Practice Team of McKinsey and SMI