Streamlining procurement processes

Retail “e-procurement” 2002: Minimizing costs and improving productivity

Introduction

The inflation and subsequent deflation of the dot-com era and a tougher economic climate are forcing retailers to focus on “back to basics” execution of their business strategies. While many companies are wary, industry leaders are looking to build e-business capabilities that drive real and lasting value.

While e-commerce euphoria was largely driven by the fear of lost market share, the e-business strategies of today are seeking sustainable competitive advantage. Electronic procurement (“e-procurement”) can be a primary source of competitive advantage for retailers in:

- *Reducing and/or avoiding costs and improving productivity* by eliminating manual, paper-based processes and empowering employee procurement within a controlled set of parameters.
- *Enforcing on-contract buying* by providing an easy-to-use tool that automatically puts procurement standards and business rules into effect.
- *Developing reporting capabilities* that provide a consolidated record of spending, supplier performance and transaction costs, which can then be used for strategic sourcing, contract negotiation and supplier relationship management.
- *Reducing purchasing cycle times and effort* by streamlining procurement processes.

The case for change

Why focus on procurement?

Effective procurement of goods for sale is the cornerstone of retail. Consequently, retailers are facing increased pressure to actively coordinate and collaborate with suppliers concerning related activities and processes.

The Internet provides significant opportunities for retailers to improve and enhance key aspects of their trade relationships and leverage their purchasing power to reduce costs. Though public business-to-business exchanges have promised to deliver these capabilities, functionality development and adoption have been slow to evolve, forcing companies to look for other options.

Retail procurement policies often vary among offices, divisions and business units, as well as across corporate and departmental levels, making it difficult to develop and communicate a cohesive supply plan. To further complicate matters, long and unpredictable cycle times, combined with the inability to adequately track inventory and integrate information, can result in excess inventory levels and carrying costs, and increase the risk of carrying obsolete stock.

Similarly, retailers have traditionally been unable to leverage total company spending due to fragmented business processes and lack of inter- and intra-departmental communication. As a result, 95 percent of all indirect purchases are made through paper-based processes, and as much as 30 percent of purchasing is done off-contract—costing 15 to 27 percent more on average. To put this into perspective, a billion-dollar company could be losing US$10 million on lost discounts alone.[1]

Opportunities to improve basic procurement abound. IBM research has shown that:

- Over 80 percent of the revenues generated by a retailer may be spent on procuring goods and services.
- Saving one U.S. purchasing dollar is comparable to increasing sales by over five U.S.dollars.
- Managing and processing a single purchase order can cost upwards of US$100.

In addition:

- A ten percent reduction in purchasing costs can create a 50 percent increase in margin.[2]
- 80 percent of purchase orders often represent only 20 percent of total monies spent.[3]
- Maverick buying—or buying indirect goods off-contract—is often done at full retail prices, and can account for as much as 30 to 45 percent of all indirect spending.[4]

Direct versus indirect procurement

The procurement of retail goods typically takes two forms: direct and indirect.

- *Direct procurement*, executed by the retail merchandising organization, refers to goods purchased directly for resale. Direct goods are typically high-volume and fairly predictable. IBM has found that most retailers today have clear direct purchasing processes that are supported by technology, and that direct procurement typically corresponds to over 60 percent of retailer revenues.
- *Indirect procurement* refers to any commodity or service that a company buys that does not result directly in finished goods for sale. Real estate, janitorial services, store fixtures, staplers, paper, furniture, contract workers, computers and travel services are all examples of indirect goods. Indirect procurement typically accounts for over 60 percent of a company's purchasing transactions.[5]

In retail today, direct and indirect goods require very different approaches. Direct goods are the lifeblood of the retail industry, and are managed by experts with deep knowledge in their areas of responsibility. Direct purchasing also tends to promulgate long-standing corporate and personal relationships based on qualitative experiences, consumer demand for brands, and "touch and feel". Meanwhile, emphasis on spot markets and impersonal supplier/buyer relationships is becoming the rule for indirect purchasing.

Indirect procurement examined

In its simplest form, indirect procurement involves five principal processes which have gone largely unchanged for the last half-century:

- *Select vendors (includes negotiating contracts and performing setup)*—These processes are cumbersome—often taking weeks to complete and complicated by unwieldy systems, drawn-out legal reviews and lengthy contracts. In many cases, practitioners opt for higher-priced goods to avoid the vendor review and setup process that accompany a new or revised vendor relationship.
- *Select goods*—Today, most companies still have shelves filled with dated paper catalogs provided by vendors. These items are available only to those with direct access—usually central purchasing—and often involve multiple calls and confusing conversations among users and purchasing specialists, as well as additional calls to numerous suppliers, to resolve issues of price, availability and delivery.
- *Requisition*—Except in cases where a company's central purchasing department is directly linked to suppliers through electronic data interchange (EDI), the requisition process remains paper-based. Multiple copies of requisition forms are usually sent through internal mail to various managers within the approval chain. Operating managers seldom know if a vendor is "on contract," or how a purchase will be affected by volume discounts.
- *Approval*—In many companies, the approval process follows two paths—functional and financial. Expensive or unusual items move up a chain of multiple sign-offs, often with long delays caused by many explanatory phone calls. Organizations can require up to seven layers of sign-offs for approval of items over US$500—from both the functional and financial sides. While the average time for approval for high-cost items is three weeks, the process can easily take months.[6]
- *Managing purchase orders (POs)*—Once final approval has been given, central purchasing collects the paperwork and transfers the information—by hand—to a purchase order form, which is usually faxed to suppliers. This process is typically accompanied by more phone calls to confirm receipt. Copies are sent to shipping and receiving and accounting and finance, then filed with various department managers.

Although the traditional paths for direct and indirect materials are blurring in some ways, indirect procurement has not received the strategic attention and thorough scrutiny that direct retail procurement processes have. As a result, the opportunities for automation, process redesign and cost savings in retail indirect procurement are substantial. Over time, retailers will align their indirect and direct procurement processes to capitalize on enterprise procurement controls, business rules, technology and economies.

Enter e-procurement

Electronic procurement is a prudent advancement in the quest to create a highly efficient virtual value chain, where complex transactions become a fluid, collaborative process between buyers and sellers. "e-procurement" continues the trend toward process automation and replacement of manual labor through information technology. By automating processes, like requisitioning approval and payment, e-procurement essentially eliminates the need for human intervention.

"e-procurement" models

The expensive and frequently complex world of one-to-one EDI exchanges and supplier enablement is unlikely to survive long in the "cheaper, faster" online world. While electronic procurement can at first seem complex and confusing, lower-cost benefits and continuous availability will ultimately win the day. Already, "e-procurement" has developed into several major public and private models for buyers and suppliers looking for better ways to handle their basic procurement processes:

Private models

- *Supply-side*—A company creates its own online catalog that allows a number of buyers to browse and purchase products online with realtime, contract-specific buying tools.
- *Buy-side*—In this example, the buyer maintains the online catalogs and databases of multiple suppliers' goods and services, and is responsible for tying all transactions into those companies' purchasing and financial systems.

Public models

- *Independent trading exchanges*—In this model, an independent Web site provides the entry point for multiple buyers and sellers to transact business for a fee or on a subscription basis.
- *Vertical trading exchanges*—This model typically focuses on the needs of one industry, with sponsorship provided by one or more industry leaders.
- *Horizontal trading exchanges*—This model cuts across industry boundaries and focuses on broad categories of goods and services that are common to many companies.
- *Auctions*—Electronic auctions, which are a subset of online trading exchanges, provide online, realtime exchange of goods through a forum in which buyers and/or sellers log on and make offers against a request. Can be private or public in form.

Third-party procurement service models

Third-party procurement services typically offer a hosted, buy-side solution—a private procurement model for enhancing supply chain efficiency and maximizing savings without incurring significant costs.

In the third-party procurement service model, the service provider builds and manages the online catalogs, often providing leveraged pricing by aggregating its subscribers' buying power.

Expected results

What you can expect from "e-procurement"

Online procurement can completely transform the way retailers purchase goods, making process efficiencies and permanently lower costs not only possible, but affordable to achieve.

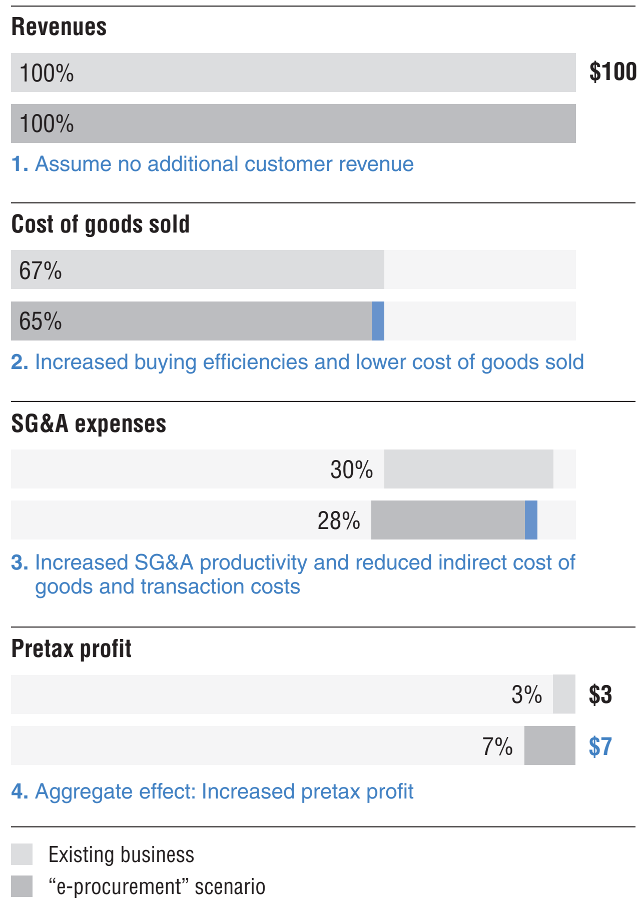
Today, most company purchasing of indirect materials is done by telephone (85 percent), fax (65 percent) and face-to-face discussions with suppliers (50 percent).[7]

To understand the scale of what automating purchasing process can do, consider data offered by those who have initiated strong "e-procurement" programs:

- Average transaction costs dropped from US$107 to US$30.[8]
- Cycle times dipped from 7.3 days to 2 days.[9]
- Average costs of generating an order fell from US$35 to less than a single dollar.[10]
- Direct purchasing costs dropped from US$60 to US$5.[11]
- The number of full-time purchasing employees plummeted from 29 to two.[12]

Clearly, "e-procurement" can have a dramatic effect on a retailer's bottom line.

Illustrative: Potential effects of e-procurement on profits



Source: IBM estimates

"e-procurement" at IBM: A success story

Perhaps the greatest documented example of "e-procurement" success is IBM itself. The company has saved more than US$9 billion—or over five percent per year of its total spending—since redesigning its purchasing processes and implementing "e-procurement" technology.

IBM results	Before	Now
Purchase order processing	30 days	1 day
Contract cycle time	6-12 months	30 days
Average length of contracts	40+ pages	6 pages
Rate of "maverick buying"	30%	Less than 2%
Internal satisfaction with procurement	40%	More than 85%
Savings: US$4.2B		

IBM awards

Purchasing Magazine: 1999 Winner of Medal of Professional Excellence

PC Week: 1999 Winner of Top ROI for web application

CFO Magazine: 1998 Reach Award

A major retailer *needed furniture for its new 23,000 square-foot office building. By utilizing a third-party procurement service, the company was able to save 38 percent off the initial quote of US$800,000.*

Office Depot *developed a sell-side "e-procurement" system to build deeper relationships with its corporate customers. The system easily plugs into the internal networks of key customers like Bank of America, which now purchases 85 percent of its office supplies from Office Depot. Today, Office Depot is selling nearly a billion dollars' worth of goods online—profitably.*[13]

While some might argue that few retailers are in the office supply business, sell-side "e-procurement" is broadly applicable to retail. Department stores with corporate and gift sales divisions, home improvement stores with contractor businesses, warehouse clubs, consumer electronics stores and others can all benefit from a sell-side electronic procurement solution for enhancing business-to-business relationships.

A ***global retailer*** *thought it had a sound employee travel program. Nonetheless, after completing a detailed assessment, the company's third-party procurement service was able to identify opportunities for an 18-percent savings in the organization's hotel program and a ten-percent savings in its European airline program. Combined, these figures were estimated at US$2.1 million on US$11.4 million of spending—savings achieved by leveraging the company's supply base, consolidating its suppliers, and strengthening policy and compliance with its travel programs.*

Price reductions are just the beginning

While many initially think of price reductions as the greatest benefit of "e-procurement", savings also come from contract compliance; transaction cost reductions; cycle-time decreases and improved information reporting. The tendency is to focus on price alone — often at the expense of more strategic considerations. With the appropriate decision-support tools provided by electronic procurement systems, retailers can begin to understand the underlying cost issues.

Price reductions

Companies have found that they can leverage their buying power and lower their cost of goods by as much as 20 percent through new reporting capabilities and centralization enabled by "e-procurement" — while reducing high-priced, off-contract maverick buying.

Contract compliance

"e-procurement" greatly improves contract compliance through increased visibility and control. As a result, retailers are able to improve supplier relationships by achieving volume quotas. The resulting process improvements also allow for headcount and effort redeployment within the organization.

Cycle-time decreases

Increasing information availability and enhancing communication can enable bottom-line savings. Many companies have found that process improvements from "e-procurement" result in cycle-time reductions of as much as 70 percent, as well as greatly improved order accuracy.[14]

Transaction cost reductions

Although prices can be driven down through better vendor management, adherence to discounts and reduction of maverick buying, the largest savings may be realized through greatly reduced transaction costs.

Information and reporting

One of the lesser-considered benefits of any electronic procurement system is its reporting capability. Perhaps for the first time, organizations will have the ability to accurately track the cost for labor, error reconciliation, lost orders, maverick buying and process delays. They will also be able to provide accurate figures for money lost through non-contract or off-contract purchasing, and calculate with a reasonable level of accuracy the volumes of spending per vendor on contracts that might allow them to negotiate improved terms or discounts.

In short, companies that invest strongly in electronic procurement can realize a significant return on their investment, and get a better grasp on where and why they spend.

Alternatives and considerations

Take stock

With a plethora of business-to-business commerce options available in the marketplace, the question is not whether to do "e-procurement", but how. To realize the value "e-procurement" offers, it is critically important to have a solid strategy that leverages marketplace best practices and includes an expert team.

An electronic procurement initiative may require rethinking business processes, changing reporting structures, retraining and relocating procurement staff, altering incentive programs and renegotiating with external partners.

So where should you start?

- Review current indirect purchasing processes in your stores, distribution centers, corporate and field offices to develop a high-level understanding of process flows, average order size and cycle time.
- Document your transaction costs, even if they are rough estimates.
- Assemble an inventory of the types of Requests for Quotation (RFQs) you create for services, products, equipment, etc.
- Analyze procurement expense documentation to understand on-contract versus off-contract procurement.
- Create a list of vendors, including products purchased, number of transactions and amount spent.

Once you have an understanding of these key factors, you can better assess your alternative courses of action and how they fit with your capabilities and strategic direction.

Recommended actions

Alternative courses of action

Do nothing—While the "do nothing" alternative is an option, its risks are great. Electronic procurement will affect the competitive position of market players and ultimately may influence the overall industry structure. Don't get caught sitting on the sidelines.

Act now—When you decide to move forward, the options are many. These include:

- *Turn to a third-party procurement service*—Participating in indirect "e-procurement" via a third-party hosted solution is a low-risk, low-cost alternative for gaining some immediate results. These services typically offer economies of scale for smaller and medium sized companies, and can be up and running in 30 days. This option also affords companies seeking to create a longer-term procurement strategy the ability to save money today, while building a solution for tomorrow.
- *Participate in a public system*—Participating in a public system is also a fairly low-risk alternative; however, functionality has been slow to develop, and in many cases participants have had to manually update their internal systems. The instability of today's public "e-markets" is also a concern. There may be a considerable amount of consolidation over the next 18 months, which could create greater integration expense, as well as some general anxiety.
- *Build a private system*—A fundamental guideline for building "e-procurement" capabilities privately or publicly is to determine whether your current procurement processes are better than those of the public exchanges. Remember that processes that deliver competitive advantage can be customized on the private exchange to drive additional value.

  One of the key advantages of the private system is that many Enterprise Resource Planning (ERP) vendors are already adding this capability to their systems, which may greatly reduce the difficulty and expense of integrating those functions. Based on the level of customization of the offering to existing and redesigned processes, this model is likely to create the greatest advantages for larger retailers.
- *Find some combination that fits your specific needs*—We believe retailers will eventually participate in an amalgamation of these models. For example, large retailers may develop a buy-side solution for direct goods—utilizing a private exchange format that enables them to participate in both vertical and horizontal public exchanges for indirect goods, and use auctions for spot-market purchasing and to establish new market pricing for goods. Meanwhile, smaller retailers may learn to rely on public models and third-party procurement services.

Other actions to evaluate:

- Consider a third-party procurement service while developing your long-term approach and strategy for procurement.
- Begin participating in public exchange auctions to capture initial cost reductions and aid in renegotiating contracts today.
- Find a good partner for procurement expertise, leading practices, change management and process re-design efforts.
- Develop a procurement strategy that is well integrated with your overall e-business strategy, with an eye towards future developments.

How IBM can help

At IBM, we understand the complex challenges that new technologies and information integration bring to the retail industry. Contact us at *insights@us.ibm.com* to investigate how we can shorten your quest for competitive success. To locate additional resources for retail business executives, please visit our Web site at:

ibm.com/services/insights.

About the Author

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