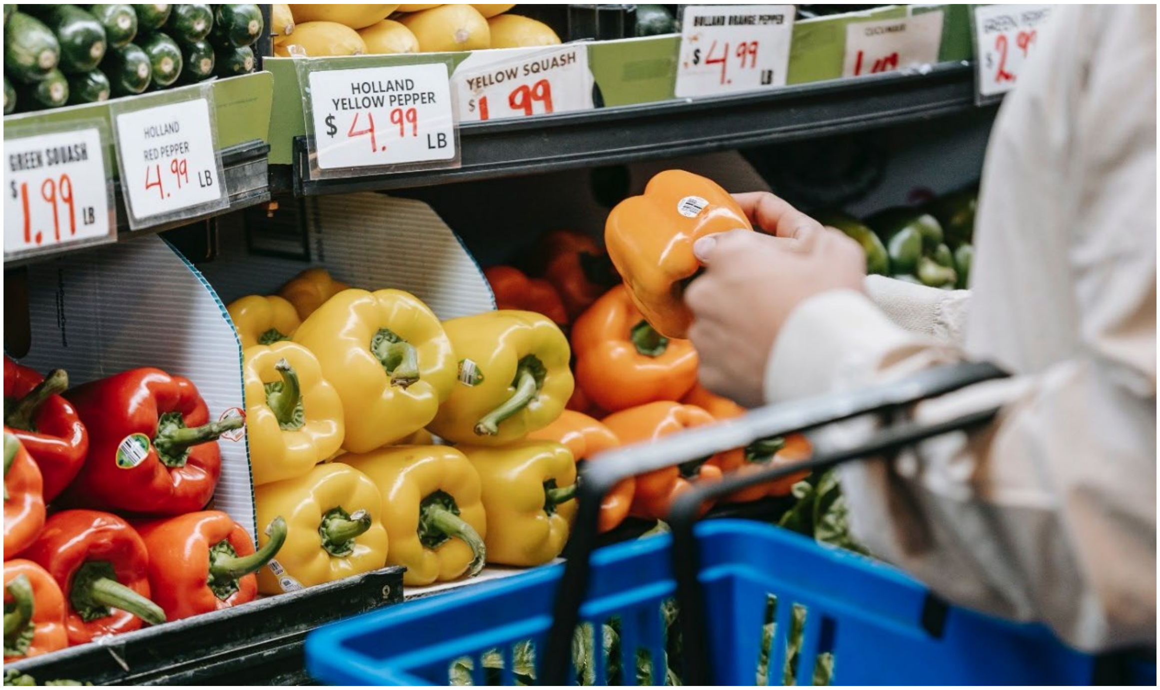


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# When sourcing can't cut prices

In most strategic sourcing programs, the primary goal is cost reduction.  The executives sponsoring a sourcing initiative assume that their company is paying too much for purchases and that prices can be cut by negotiating with incumbents or through competitive bidding.  However, there are times when sourcing teams get a nasty surprise and the expected savings don’t materialize.

There are many ways to generate value through strategic sourcing besides lower prices.  Benefits of sourcing the optimal products and services include reduced risk, lower usage, improved operating efficiencies, or higher customer satisfaction.  However, for purposes of this article, I will focus on the premise that cost reduction is the primary goal of most sourcing programs, and that sourcing—when driven from a procurement point of view (which does not have to be the case)—focuses firstly on price.  The sourcing team will estimate the potential cost reduction by using benchmarks and/or should-cost pricing.  “We currently pay X, but we could, or should, pay only Y, so the potential dollar savings is total units purchased times X minus Y.  The savings percentage is X minus Y, divided by X.”

When determining the savings opportunity, price benchmarking is a good place to start, but it's not the most insightful. All suppliers may set high prices because they can get away with it. This is not the price you want to pay, and you should understand when it's going on.

On the other hand, some suppliers may set pricing too low to make that transaction profitable. Non-profitable pricing is not sustainable, and while you may want to take advantage of a sale when it occurs, you need to understand the supplier's, and the market's, sustainable price level. If you suspect that "market" prices are abnormally high or low (i.e., that they don't reflect a supplier's costs plus a reasonable profit), then you should build a should-cost model to understand how far pricing is deviating from sustainable levels, and perhaps also develop insight into the supplier's motivations for tweaking the pricing (up, or down).

## Key takeaways

- ☐ Sometimes suppliers are able to protect high margins and won't respond to negotiation from valued customers, or from the pressure of competitors in the market place. These situations are usually discernible before initiating a strategic sourcing initiative.

- ☐ "Strategic" sourcing is about value, not just price reduction. Value means higher sustained EBITDA. Lower total cost of ownership, higher operating efficiencies, better customer outcomes, and lower risk are all factors that contribute to higher sustained EBITDA.

## Conditions when suppliers price competitively, or even lower

Some reasons suppliers may price close to (or even below) a profitable level:

- The product/service is sufficiently commoditized to make price comparisons easy, AND the market is competitive, so suppliers need to maintain pricing in line with each other to stay in the game.
- A particular supplier may have unexpected excess capacity available; any covering revenue is better than none.
- The production costs of a particular supplier may be favorable for the particular volume or pattern of demand of a particular buyer: if the buyer's volume of spend, or lot sizes, match the available capacity of a production line, that supplier may have an economic advantage over other suppliers whose production isn't set up to meet that particular demand.
- A supplier new to a market may choose to buy market share for a transitional period by beating competitors on pricing.
- A supplier may wish to acquire a targeted customer or market segment and may offer discounted pricing to win a first sale. But after the supplier has achieved their goal, pricing will revert to profitable levels.
- A supplier may be practicing predatory pricing (for example, dumping) to kill off competitors, and will raise prices once they have a monopoly.

There are other reasons, of course, but these illustrate the range of motivations for suppliers: preserving or building revenues or market share, situational economics (when a specific demand profile matches the production efficiencies of the producer), tactical reasons (unexpected available capacity), and strategic reasons (developing a particular key customer relationship or penetrating a market).

## Conditions when suppliers do not compete...at least, not on pricing

Often, pricing works the other way: pricing is well above the point where the supplier covers actual costs plus a reasonable, sustainable profit. It's not always obvious, a priori, why this will be the case. In the early 90s, I was consulting to a major regional bank in the Midwest. I attempted to lead a sourcing effort to get "market" pricing for services provided by U.S. Check (now AirNet Express). U.S. Check was a nearly exclusive provider of overnight air transport of physical paper checks between banks. At the time, before regulations permitted electronic release of funds against a check, the paper check had to be returned to the issuing bank to release payments. Because of the time value of money and the impatience of customers, checks were flown overnight between banking centers to expedite the clearing process. The rates the bank paid for the service seemed overpriced compared to the should-cost of operating an overnight expedited shipment service. I learned—the hard way—that U.S. Check had a near-monopoly position within my customer's market. There was no competition, therefore, U.S. Check **was** "the market". It was then that I internalized that competitive bidding really means there must be competitors.

There are many reasons why competitive bidding may not take place. Here are just a few:

- There are no competitors in the local market (as was the case in the example above).
- While there may be ostensible competition, the specific product or service that a company is buying is unique in some way, limiting options to one supplier. In effect, there is no competition. Some examples:
  - Protected proprietary technology, like patents, or ostensibly unprotected but hard-to-replicate capabilities (e.g., a "secret sauce").
  - Best in class quality that makes one company's products or services a unique fit for a customer's needs, even if other customers see the product category as a commodity.
- Limited production capacity across the industry. In recent years, the production capacity of the PVC industry has barely matched global demand. When even one plant has an outage or extended shut down, pricing and availability across the entire industry can be affected. In such a case, buyers may be happy just to get capacity allocated to them, even if pricing is clearly higher than production costs would suggest.
- Capacity manipulation by suppliers, who restrict output to keep prices high. OPEC manipulation of oil production is an example.
- Regulatory constraints on production and distribution, including quotas and, indirectly, tariffs.
- Logistics constraints: the blockage of the Suez Canal in 2021 and the two year backup at the Ports of Los Angeles and of Long Beach, ending in November of 2022, illustrate this problem. A more subtle version of this is when certain shipping lanes are constrained, perhaps by volume or type of vessel, competing demands in other routes, or disruptions due to weather or port activities. Such constraints may also be due to regulatory issues.
- Macroeconomic factors such as inflation and perceived risks in the larger economy, that cause suppliers to become skittish about accepting commitments for large volumes and over long time periods. They may fear that their own costs will go up in the meantime, or that they will lose the opportunity to sell at higher margins to more lucrative customers.
- Some combination of any of the factors above; for example, brand/reputation, measurably differentiated performance of their products in the field, quality of technical service and technical support, global distribution capabilities, and omnipresence across

diverse markets (meaning that wherever you go in the world, you can find spare parts and qualified technicians), makes Caterpillar one of the most durable, and most expensive, brands, relative to competitors.

**Actions you can take:**

- ☐ Perform a strategic sourcing diagnostic before locking down scope, targets, timeframe.
- ☐ In particular, use should-cost modeling to learn when suppliers are not behaving in a strictly competitive manner.
- ☐ Manage stakeholder expectations to keep open the option to deliver different kinds of value; avoid being myopically focused on price.
- ☐ When the market conditions are challenging, it's especially important to be curious, to think laterally, and to be creative.

## How can you detect a non-competitive market?

When you are initiating a sourcing process, how can you determine if some or all suppliers are not setting prices to compete directly with other potential suppliers? In other words, how can you avoid the embarrassment of preparing and tendering an RFP, or launching a direct negotiation process with an incumbent supplier, just to discover late in the game that suppliers are not making price concession (or, worse yet, are taking this as an opportunity to raise prices and/or cut supply)?

The necessary information may be readily available if you know where to look. Here are frequent sources of insight about what's going on in an industry:

- Develop a should cost model. Break down the product/ service into its components and build up the costs. While doing this, analyze the dynamics for each of the components' supply markets. For example, for packaging, you need to understand the market for the raw materials, the process for converting the materials into packaging, the market for the machinery that performs the processing, the market for design work (engineering and creative), and the materials handling (inventorying, transportation, shelf life, handling requirements, etc.) of the packaging.
- Review contracts and service level agreements to determine if there are terms related to exclusive access to proprietary technology or services
- Review contracts to confirm that you have the flexibility to end a contract or rebid the category
- Talk with the current buyer and the end-users in your (or your client's) organization; these individuals have already been talking with suppliers; it's easy to be dismissive and presume that the day-to-day buyer isn't driving hard enough to get savings out of a spend category. Instead, assume that individuals are well-intentioned and motivated. If pricing is sub-optimal, there may be internal barriers that prevent accessing the best supplier relationships, and/or the supply market is constrained.
- Talk directly with the suppliers: ask them about industry trends as well as about their companies' strategies; questions can be included in a Request for Information
- Undertake market research: start with Google for industry news and free market research (for example, government or Federal Reserve Bank data and analysis); read the annual reports of major suppliers, and the analysis of investment analysts, who make it their job to understand their markets. If you need to go deeper, consider paying for market research like IBISWorld reports or to speak with an industry expert (e.g., through GLG or similar providers). At each stage, use the insight you gain to determine whether the uncertainty justifies spending more money and time.

In early 2021, I stepped into a sourcing program which had already launched. The consulting sales team had not performed a diagnostic. For a range of largely unrelated reasons (most having nothing to do with Covid), major spend categories were severely constrained. This included hot rolled steel, PVC, contract labor, wood pallets, and other materials. If we had taken just a week to assess the risks in each of the major spend categories, we could have managed our client's expectations accordingly, and executed a less reactive process. To compensate for the ineffectiveness—indeed, the irrelevance—of competitive bidding to the major categories, we had to double the number of categories (and sourcing work streams) to win back savings. At the same time, we continued to look for creative ways to squeeze savings out of the original set of commodities, while managing the risks of constraints in the market.

In the end, we were successful in identifying savings potential that was within the range of the client's original expectations. However, it came at the cost of extended project duration, a significantly higher work load and stress for the consulting and client team, and frustration by the client's leadership team.

## Final thoughts

It is essential to perform a diagnostic before finalizing the targets, priorities, timeframe, and resourcing for a sourcing program. This diagnostic includes getting a read on market conditions for each of the proposed commodities. It is important to have some idea of what risks lie ahead; this may be a solid understanding of capacity constraints, or even calling out the unknowns and therefore lowering the bottom end of the expected savings range.

Unexpected barriers in the marketplace force lateral thinking. Some of the most valuable and durable benefits I've delivered to clients were not from price reductions. Instead, I've found ways to cut consumption and solutions that enabled more efficient production, faster time to market, and better quality delivered to the customer of the client.

Procurement is typically about getting the right item at a reasonable price at the right time. Strategic sourcing is about delivering value—higher EBITDA, lower risk, better customer satisfaction—in connection with fit-for-purpose supplier relationships. Creativity and curiosity, rather than rote methodology, are essential.

## Author

Peter Benda is president of DecisionPoint, Inc., which provides consulting services to help leaders make good decisions.  His experience ranges from startups to an executive role at a Fortune 200 company.  As a management consultant, he has served companies in major sectors (energy, natural resources, services, banking, manufacturing, government, and defense), functions (procurement, operational improvement, governance), and continents and cultures. He has consulted as a strategic sourcing and supply chain expert for over 30 years.

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