OLIVER WYMAN

PROCUREMENT OUTSOURCING

HOW TO AVOID PROCESS COMPLEXITY AND DISAPPOINTING RESULTS

MARSH GUY CARPENTER MERCER OLIVER WYMAN

MARSH & McLENNAN COMPANIES

Procurement divisions are currently focusing efforts on performance and efficiency optimization and some CPOs are wondering if procurement outsourcing will be their golden ticket. This process involves the transfer of procurement processes – such as sourcing, category, and transaction management – to a third party. Moreover, a promising lever may exist in robotic process automation (RPA) and marketplaces.

In 2016, the global market for procurement outsourcing was approximately $3 billion and had an annual growth rate of around 14 percent. Over the past three years, the procurement-outsourcing market has grown 13 percent on average each year[1]. Despite the strong growth, procurement outsourcing represents a small percentage of organizations' direct and indirect spending.

Only a fraction of organizations (28 percent of those surveyed in the United States) have engaged in procurement outsourcing[2] thus far. Nine out of ten companies that have engaged in such efforts reported positive experiences and say they would continue them. On the other hand, companies that have not yet undertaken outsourcing are reluctant to do so.

Geographically speaking, adoption rates are uneven. North America is far ahead of the curve in the number of procurement outsourcing contracts signed, accounting for 54 percent of total contracts. Europe and Australia/New Zealand are the next two largest regions, accounting for 27 percent and 7 percent, respectively. Together, North America and Europe represent more than three-quarters of all such contracts signed worldwide.

Procurement outsourcing is enjoying significant growth. Nonetheless, Chief Procurement Officers (CPOs) should be cautious: In Oliver Wyman's experience, many companies struggle with the process and are disappointed by the results (half the CPOs interviewed during the SIG-OW 2015 Procurement Maturity Benchmark were unsatisfied). A number of questions remain: Is procurement outsourcing really something worth considering? Are there viable alternatives to it? Oliver Wyman believes when procurement outsourcing is done right, it will deliver impactful results. However, the use cases are specific and rather limited. We will address these topics and discuss, moreover, procurement maturity levels, operating models and category design strategy.

1 Technavio, Global Procurement Outsourcing market 2015–2019

2 APQC, Supply Chain Management Review, November 2015

THERE IS NO "SILVER BULLET" IN PROCUREMENT

While the benefits of outsourcing – the flexibility, savings, and expertise it promises – are surely appealing, CPO's will be disappointed by the results if their expectations are too high. Frequently, CPOs' main objective in outsourcing is cost savings – on both the cost of goods and on internal resources – yet more often than not, that goal is not achieved. All the same, procurement outsourcing presents the possibility of freeing up internal resources from low-value categories for redeployment to high value-add areas.

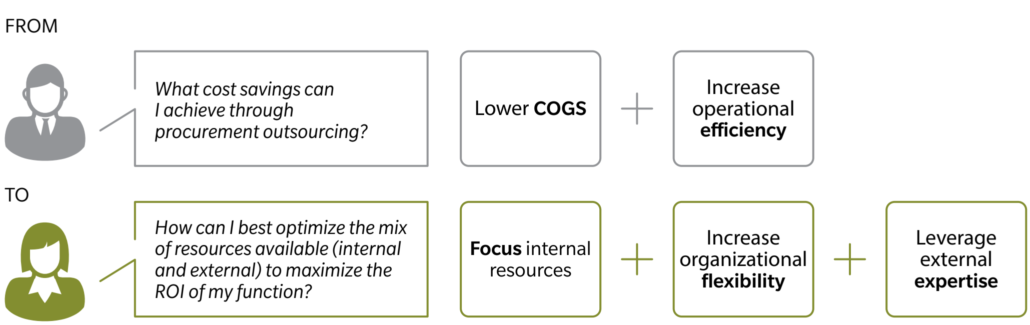
In procurement's current push to become more efficient and agile, CPOs will be presented with a number of options. Although there is no one-size-fits-all solution, a best practice is to leverage outsourcing in addition to RPA and marketplaces to meet the specific needs of a given procurement organization.

Robotic Process Automation (RPA) – With modern advancements in technology, RPA employs machine learning and artificial intelligence to automate tasks previously performed manually by humans. Given that it is still in the experimental phase, RPA is currently being used only for repetitive, low-complexity purchasing tasks. However, continued development and innovation over the next five-to-10 years will likely expand its capabilities into complex procurement activities.

Marketplaces – Amazon Business and Alibaba are prime examples of procurement marketplaces. These marketplaces offer attractive prices for common indirect category products. This is especially appealing to small- and medium-sized businesses for low criticality categories, as the marketplaces are user intuitive and streamline traditional procurement processes. In July of 2017, Amazon Business had over 1 million customers1[3] (tripling in size from 2016). During this time, the number of sellers on the platform also increased from 30,000 to 85,000. With the announcement in late 2017 of the strategic partnership between Amazon Business and Coupa (Coupa Open Buy), there is little doubt that such marketplaces will continue to grow and increase in adoption.

When contemplating whether procurement outsourcing will work for your organization, it is important to confirm that it can fulfill your strategic objectives and desired outcomes. Such clarification may necessitate important changes in the mindset of the organization. (See Exhibit 1.)

Exhibit 1: Unlocking the potential benefits from procurement outsourcing requires a change in mindset



3 CNBC: Amazon's competitor to Staples and industrial supply shops now has 1 million customers

ADAPT TO THE MATURITY STAGE OF YOUR ORGANIZATION

Procurement outsourcing is a valid option for any organization beyond its early phases of maturity, regardless of industry. (See Exhibit 2.) Adoption currently varies across sectors, but companies in a broad range of industries have opted to outsource at least part of their procurement operations.

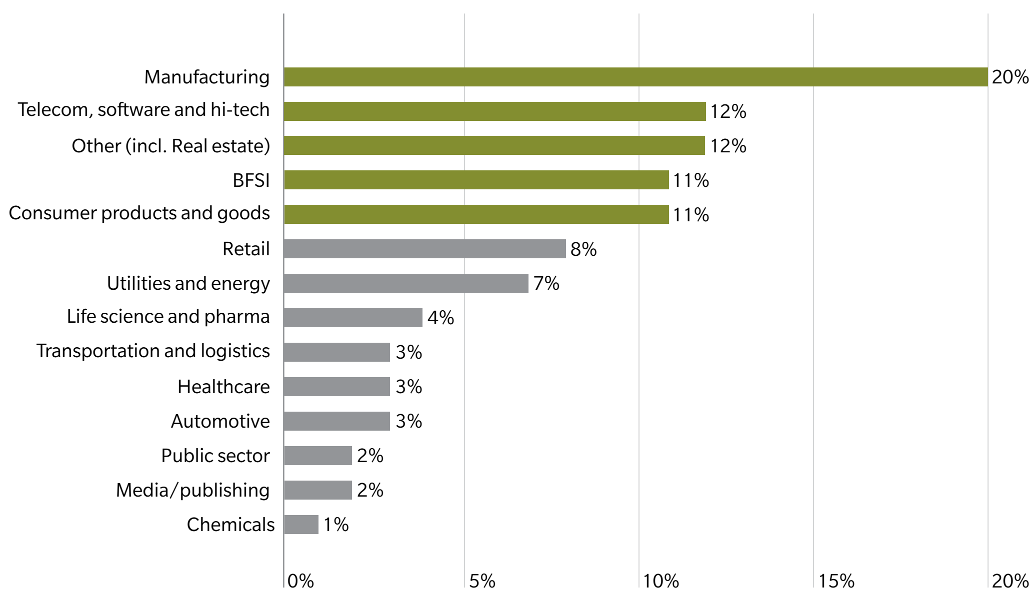
Depending on your organization's maturity, however, the relevant operating models and expected benefits will be different. As discussed in Oliver Wyman's *Designing the Perfect Procurement Operating Model* point of view article, there are three major stages of maturity:

Emergent phase: In their first phase, procurement organizations tend to follow a "coordinated model." The focus then is mostly on trying to influence internal stakeholders and achieve quick wins.

Consolidation phase: The procurement function is now given ambitious economic objectives, based not only on price levers, but also on a mandate to challenge demand needs. During this consolidation phase, increasing coverage rate is a priority for CPOs.

Equilibrium phase: After consolidating procurement activities and formalizing essential operational processes, most mature companies tend to redistribute parts of strategic sourcing directly into their business units. The procurement function then morphs from a central organization to a fully integrated and embedded function.

Exhibit 2: Average percentage of procurement outsourcing work, by industry (percentage of deal count)



Source: HfS Research

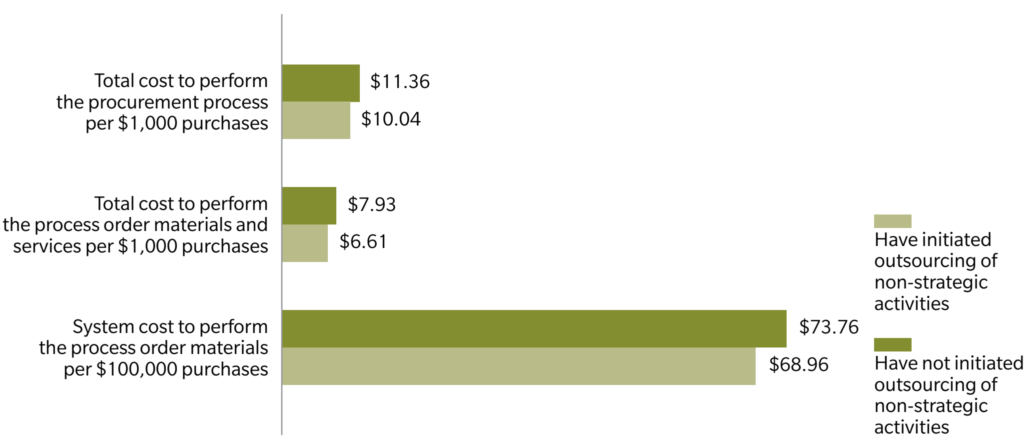
At the earliest stages, procurement's available levers involve buying cheaply, since little has yet been done to pool volumes or negotiate prices. In this phase, procurement outsourcing can provide short-term benefits by tapping into larger buying volumes, leveraging existing relationships and optimized supplier panels to buy at better prices. Such benefits are not sustainable and CPOs should understand that significant, long-term savings cannot be generated in this way. Indeed, companies that have outsourced non-strategic activities tend to face slightly higher procurement-associated costs. (See Exhibit 3.)

In later stages of maturity, outsourcing can effectively offload now-mechanical tasks to a third-party provider – and redirect skilled employees to tackle new procurement challenges. On such a model, procurement-outsourcing resources are used to augment an organization's staff, allowing for agile flexibility to scale.

Moreover, outsourcing contracts require dedicated internal resources to monitor vendors and track the execution of contracted work. The effort involved in managing a third-party provider should not be underestimated. Outsourced relationships often entail significantly more recordkeeping, attention, and hands-on management than anticipated.

Another common misconception around procurement outsourcing concerns the expertise that third-party providers often claim to possess. Many business categories require large, complex, and customized contracts and arrangements that service providers may find difficult to satisfy. Additionally, there is often high turnover in outsourcing providers leading to constant "ramp up" times. Outsourcing these complex, highly nuanced categories for third-party expertise will most likely leave CPOs disappointed.

Exhibit 3: Outsourcing of non-strategic activities and procurement cost



Source: APQC

SET UP THE RIGHT OPERATING STRUCTURE AND CONTRACTS

Given the maturity of your procurement organization, you know what to expect from procurement outsourcing. Still, the question remains: How do you leverage third-party organizations and establish optimal operating structures and contracts? There are several different approaches, each possessing distinct advantages and disadvantages. (See Exhibit 4.)

For a longer-term approach to outsourcing, there are two routes: allocating functions step-by-step or all at once. The former method allows an organization to test the waters and tailor its interactions with providers over time. Benefits will accrue slower in comparison to the second, all-at-once approach. The "big bang" strategy is higher risk, higher reward, as missteps will have larger and longer-lasting impacts and will be harder to reverse and take back under control.

Organizations that leverage procurement outsourcing are typically most successful in utilizing third-party vendors on a project-by-project basis. Whenever a company has a large project entering new sourcing territory, collaboration with third-party vendors allows benefits to accrue to the project without requiring more serious, long-term contracts.

Exhibit 4: Approaches to procurement outsourcing

ONE STEP AT A TIME	PRIORITY PROJECTS ONLY	BIG BANG
Experiment with safe categories and capabilities first; expand when benefits materialize	Award prioritized projects to specialized service providers with highest expected impact	Outsource entire parts of the procurement function in a single major transformation
✓ Low-risk and commitment Explore and exploit strengths of model	✓ Focused execution Limited project distraction for internal resources	✓ Immediate scaling of benefits Exploit end-to-end service provider capabilities
✗ Benefits emerge and accrue slowly Limited scaling and leverage in early stages	✗ Limited transferability of strengths and capabilities across projects	✗ Limited strategic control Missteps have large and long-term impact

Regardless of the preferred approach, pilot programs are always advisable as a first test of a relationship before any serious commitments are made.

Pricing schemes for procurement outsourcing contracts take various shapes, but are typically structured around three main drivers: resources, transactions, and performance. (See Exhibit 5.)

While full-time employee (FTE)-based models remain a prevalent choice, gain-sharing savings-based outcomes can also be an attractive option. (See Exhibit 6.)

Exhibit 5: Contract and pricing types

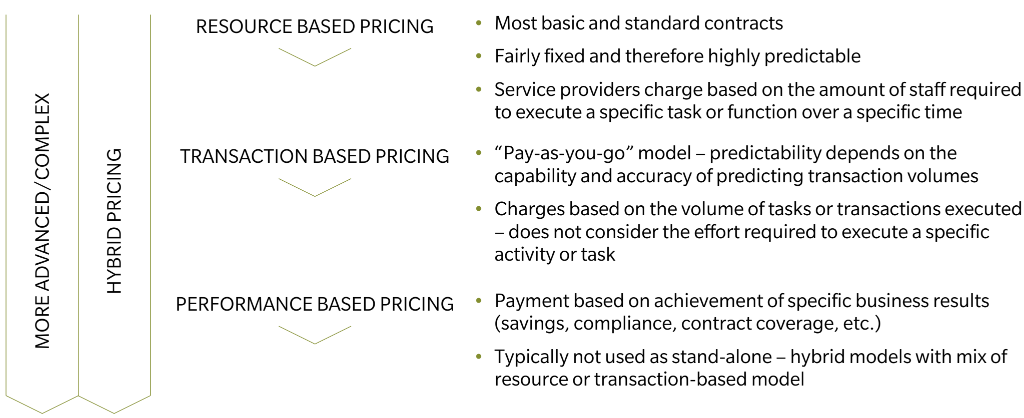
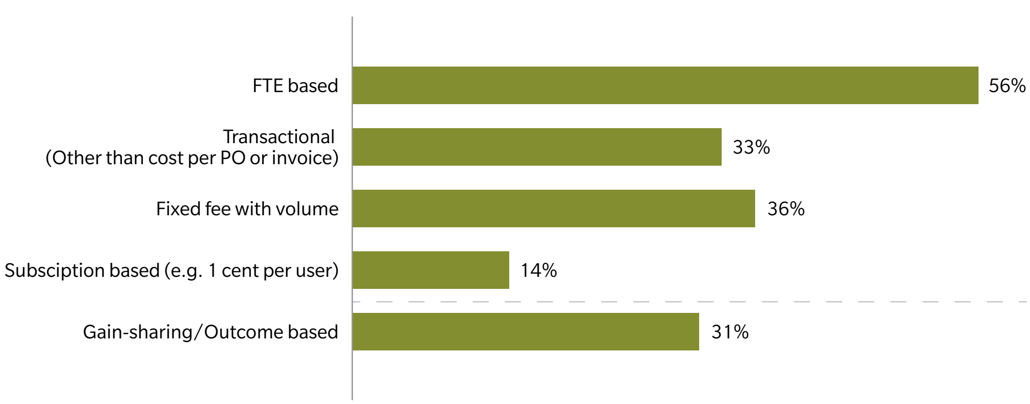


Exhibit 6: Contract type distribution – Fee structure



Source: HfS Research

DESIGN OUTSOURCING STRATEGY AT CATEGORY LEVEL

Certain structural risks limit the opportunities presented by the process, as outsourcing shifts bargaining power to vendors. This limits an organization's ownership and control over the sourcing category.

In designing an effective by-category outsourcing strategy, organizations should assess four key dimensions: savings potential, criticality, internal stakes, and organizational expertise:

Savings potential: To understand the maturity level of a category, assess whether significant savings can be achieved in a given category within three years. It is generally riskier to outsource immature categories – those categories in which the organization can independently generate significant savings in the immediate future.

Criticality: Each category should be evaluated along two dimensions: business impact and category sensitivity. In assessing business impact, CPOs need to ask: Is this spending category critical to day-to-day business operations? And in gauging category sensitivity, ask yourself: how important is this category for end users?

- Spend categories critical to the business or end users are best kept in-house, as maintaining flexibility and control is of the utmost importance. Relinquishing strategic control over core categories can pose significant risks to an organization.
- By contrast, categories of low criticality are good candidates for outsourcing, since purchasing failures here would not jeopardize a company's welfare.

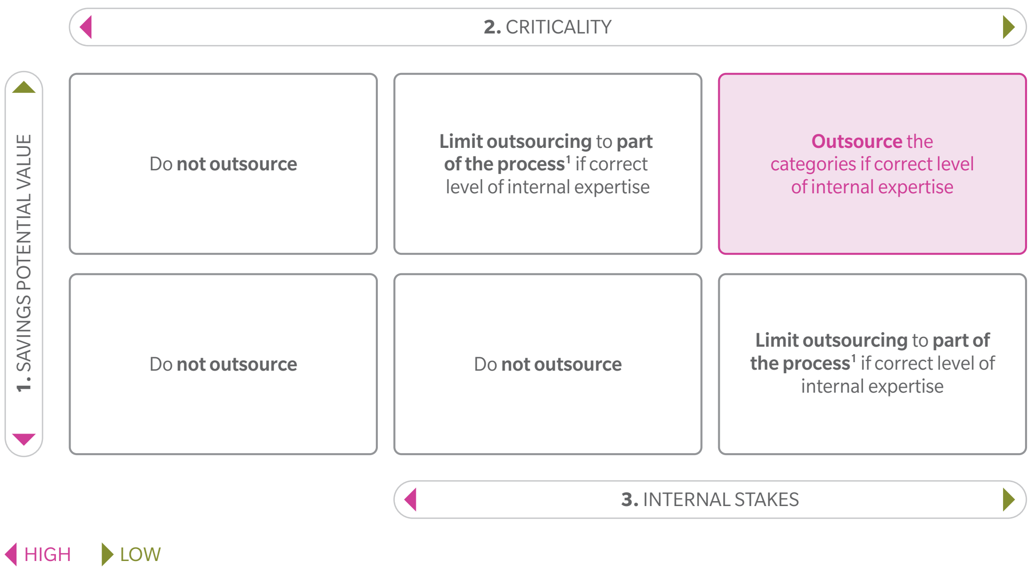
Internal stakes: There are two dimensions to evaluate the internal stakes of a category.

Performance drivers: What are the key performance drivers of this sourcing category? Assess the potential value of employing simple "buying cheaper" or "spending smarter" levers. Generally, categories driven by the more strategic spending-smarter lever are more difficult to outsource.

Stakeholder complexity: What is the category's stakeholder complexity level (specifications and governance)? This dimension will help prioritize the sequence in which categories should be outsourced. It is best to first secure gains from less-sensitive categories before turning to more challenging ones.

Organizational expertise in a category: Has the organization developed strong internal processes that position it to handle procurement for a given category? Does the organization employ sophisticated techniques that would be difficult for a third party to replicate?

Exhibit 7: Structural decision matrix for outsourcing purchasing activities of a given category



Assessed along these dimensions, categories can be placed in one of six decision zones in the matrix. (See Exhibit 7.)

This matrix, joined with honest appraisals of organizational expertise, will allow firms to decide whether to outsource all or part of its purchasing for any given category. For categories in which outsourcing all procurement would be inappropriate, it may still be attractive to outsource significant portions of the process. Third-party providers can, for instance, handle the risk evaluation of suppliers.

Available procurement-outsourcing services encompass a number of tasks in the procurement process for which outsourcing may indeed be an appealing option.

PATH FORWARD

For today's procurement organizations, outsourcing has alternately proven highly successful and deeply disappointing. There is no one-size-fits-all approach to this process.

Disappointments are the result of misconceptions and unrealistic expectations. CPOs should use outsourcing to optimally allocate resources and focus internal capabilities on high stakes categories, rather than as a means to achieve cost savings (cost of goods sold and/or resources).

It is also important to note that outsourcing is just one (of a few) ways to manage categories that are low criticality and/or of low savings potential. Depending on the size and needs of your procurement organization, robotic process automation (RPA) or marketplaces could be a better solution.

When deciding whether procurement outsourcing is appropriate for them, organizations should always consider the following steps:

- Clearly define objectives upfront, as well as expected benefits toward stated objectives
- Take into account multiple objectives beyond cost savings – outsourcing relationships with a third party is often very complex and should not be defined by the single goal of cutting costs
- Design a procurement-outsourcing strategy at the category level, based on an assessment of the four key dimensions: savings potential, criticality, internal stakes, and the organization's category expertise
- Categories and processes being considered for outsourcing should currently be well-managed; otherwise, pre-existing challenges will simply be transferred to the third-party providers
- For categories and activities that are outsourced, implement rigorous monitoring to manage third-party vendors and contracts and ultimately maintain control over the category

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

Oliver Wyman's global Operations Practice specializes in end-to-end operations transformation capabilities to address costs, risks, efficiency, and effectiveness. Our global team offers a comprehensive and expert set of functional capabilities and high-impact solutions to address the key issues faced by Chief Operating Officers and Chief Procurement Officers across industries.

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

AUTHORS

Xavier Nouguès, Head of Value Sourcing

Damien Calderini, Partner

Stephan Picard, Principal

David Yoo, Engagement Manager

CONTACTS

Lars Stolz, Global Head of Operations
lars.stolz@oliverwyman.com

Greg Kochersperger, Europe, Middle East, and Asia Head of Operations
gregory.kochersperger@oliverwyman.com

John Seeliger, Americas Head of Operations
john.seeliger@oliverwyman.com

Xavier Nouguès, Head of Value Sourcing
xavier.nougues@oliverwyman.com

Michael Lierow, Head of Supply Chain
michael.lierow@oliverwyman.com

Brian Prentice, Head of Manufacturing and Process Operations
brian.prentice@oliverwyman.com

Alex Lyall, Head of Digital Operations
alex.lyall@oliverwyman.com

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