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# The Purchasing Chessboard

64 Methods to Reduce Costs  
and Increase Value  
with Suppliers

**Second Edition**



Springer

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*“Our success as consultants will depend upon the essential rightness of the advice we give and our capacity for convincing those in authority that it is good.”*

Andrew Thomas Kearney  
(1892 – 1962)

# Preface

When we began work on the original, 2008 edition of *The Purchasing Chessboard* we had an ambitious goal in mind: to write a book with a comprehensive strategy for tackling challenges in the field of procurement. That first edition was even more successful than we hoped. The book became a bestseller in the procurement category and has remained on the bestseller list ever since.

Obviously, for us as authors, this warm reception has been very good news—not only because so many companies have invited us to speak about the Purchasing Chessboard<sup>®</sup>, which in many cases led to sizeable consulting projects, but also because it presented an opportunity for us to learn about numerous firms around the world, big and small, that adopted the Purchasing Chessboard concept as their main procurement strategy tool. Their numbers go into the hundreds. And every day we hear about new companies that have joined the ranks of Purchasing Chessboard aficionados. We are especially gratified to hear of the prestigious blue-chip Chessboarders—companies from China, Germany, India, Korea, Russia, the United Kingdom, and the United States. After all, since the days of Gutenberg and the first printing press, influencing the thinking and actions of people has been a central idea behind book publishing.

We were encouraged to write this follow-on edition of *The Purchasing Chessboard* to address some of the new realities in the world of procure-

ment, because what might have been considered acceptable performance in procurement just four years ago is seen as subpar today. The strategic aspects of procurement have become even more critical since 2008, and industry volatility has become ... well, more volatile, and both are triggering a heavy push from top management to get procurement to be more strategic. Internally, procurement has new means at hand. Powerful analysis tools have become readily available and leaders are tapping into rich talent pools. Together, these considerations account for the book's totally new and expanded introduction.

Furthermore, and truthfully, we as authors know more today than we did back in 2008. When we conceived the Purchasing Chessboard concept, we saw it purely as a tool to derive the best method for reducing costs and increasing value when engaging a supplier. Procurement executives working with the concept have shown us that it can do so much more. Yet, despite all of the great achievements procurement executives and their teams are making, they do not always receive the recognition they deserve. In response to this, A.T. Kearney has developed an unequivocal approach to measure procurement's impact, the Return on Supply Management Assets (ROSMA<sup>®</sup>) framework. See Chapter 5 for a discussion of ROSMA and its findings.

The core chapters of this edition of *The Purchasing Chessboard* are largely the same as in the original edition. The basics of supply power versus demand power has worked for generations—selling in the bazaars of Babylon, raising trading powers such as Venice to greatness, furnishing the foundation of the British Empire—and is still valid today! About half of the case studies have been updated.

We very much like the notion of “standing on the shoulders of giants.” Without the work of Tom Slaight and Manfred Türks decades ago, A.T. Kearney's procurement practice would not be what it is today. And without the work of our colleagues today, writing this book would not

have been possible. Due to space considerations we have to limit acknowledgements to those who gave us the most valuable assistance, both as discussion partners and as rich sources of ideas: Inigo Aranzabal (Madrid), Johan Aurik (Brussels), John Blascovich (New York), Reuben Chaudhury (New York), Laurent Chevreux (Paris), Charles Davis (London), Stephen Easton (London), Fred Eng (New York), Kai Engel (Düsseldorf), Richard Forrest (London), Axel Freyberg (Berlin), Jules Goffre (Munich), Florian Haslauer (Vienna), Martin Haubensak (Düsseldorf), Terry Innerst (Sydney), Günter Jordan (Munich), Bo Kaunitz (Stockholm), Götz Klink (Stuttgart), Ruslan Korzh (Moscow), Rick Kozole (Washington, D.C.) John Kurtz (Jakarta), Daniel Mahler (Zurich), Alexander Malkwitz (Düsseldorf), Federico Mariscotti (Dubai), Michael McCool (Hong Kong), Xavier Mesnard (Paris), Dietrich Neumann (Berlin), Kurt Oswald (Vienna), Peter Pfeiffer (Düsseldorf), James Pearce (London), Wim Plaizier (Amsterdam), Pieter Riedstra (Chicago), Thomas Rings (Munich), Luca Rossi (Milan), Marco Santino (Rome), Oliver Scheel (Düsseldorf), Sieghart Scheiter (Düsseldorf), Niko Soellner (Düsseldorf), Martin Sonnenschein (Berlin), Dan Starta (Dubai), Wolfgang Steck (Zurich), Markus Stricker (São Paolo), Frank Thewihsen (Düsseldorf), Jan Fokke van den Bosch (Amsterdam), Patrick Van Den Bossche (Washington), Jan Van der Oord (Amsterdam), Bart Van Dijk (Amsterdam), Mirko Warschun (Munich), and Peter Wessmann (Düsseldorf).

We are confident that *The Purchasing Chessboard* will be equally useful to all those involved in the business of procurement—from the CEO to the staff in the field. We hope it will encourage our readers to make real and tangible improvements in their procurement procedures. Enjoy!

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# Table of Contents

<b>Preface .....</b>	<b>VII</b>
<b>Table of Contents .....</b>	<b>XI</b>
<b>1     Procurement: the case for clout .....</b>	<b>1</b>
1.1   It is a jungle out there .....	1
Extreme competition .....	2
Extreme volatility .....	3
Quest for sustainability .....	4
1.2   Getting more strategic after all .....	5
Strategic integration .....	5
Procurement-driven innovation .....	6
Bottom-line impact .....	6
Organizational setup .....	7
Emerging markets .....	8
Supply risk management .....	8
Talent management .....	9

<b>2</b>	<b>From four basic strategies to 64 methods .....</b>	<b>11</b>
2.1	Manage spend .....	15
	Demand management.....	16
	Co-sourcing .....	17
	Volume bundling.....	18
	Commercial data mining .....	19
2.2	Change the nature of demand .....	19
	Risk management.....	20
	Innovation breakthrough.....	21
	Technical data mining .....	22
	Re-specification.....	23
2.3	Leverage competition among suppliers.....	24
	Globalization.....	24
	Tendering.....	25
	Target pricing .....	26
	Supplier pricing review.....	27
2.4	Seek joint advantage with supplier .....	28
	Integrated operations planning .....	29
	Value chain management .....	30
	Cost partnership .....	31
	Value partnership .....	32
<b>3</b>	<b>Using the Purchasing Chessboard .....</b>	<b>35</b>
3.1	A company's fingerprint on the Purchasing Chessboard .....	38
3.2	Example of applying the Purchasing Chessboard.....	41

<b>4</b>	<b>The Purchasing Chessboard .....</b>	<b>53</b>
<b>A1</b>	Demand reduction .....	55
<b>A2</b>	Compliance management.....	57
<b>A3</b>	Procurement outsourcing .....	60
<b>A4</b>	Sourcing community.....	62
<b>A5</b>	Bottleneck management .....	65
<b>A6</b>	Vertical integration .....	69
<b>A7</b>	Core-cost analysis.....	70
<b>A8</b>	Invention on demand .....	73
<b>B1</b>	Contract management.....	77
<b>B2</b>	Closed loop spend management.....	80
<b>B3</b>	Mega supplier strategy .....	81
<b>B4</b>	Buying consortia .....	83
<b>B5</b>	Political framework management.....	84
<b>B6</b>	Intelligent deal structure .....	86
<b>B7</b>	Design for sourcing .....	88
<b>B8</b>	Leverage innovation network.....	90

---

<b>C1</b>	Bundling across product lines .....	93
<b>C2</b>	Supplier consolidation .....	95
<b>C3</b>	Master data management .....	97
<b>C4</b>	Cost-data mining .....	100
<b>C5</b>	Product benchmark .....	101
<b>C6</b>	Composite benchmark .....	103
<b>C7</b>	Product teardown .....	107
<b>C8</b>	Functionality assessment .....	108
<b>D1</b>	Bundling across sites .....	111
<b>D2</b>	Bundling across generations.....	113
<b>D3</b>	Spend transparency .....	114
<b>D4</b>	Standardization .....	116
<b>D5</b>	Complexity reduction .....	119
<b>D6</b>	Process benchmark .....	121
<b>D7</b>	Design for manufacture .....	124
<b>D8</b>	Specification assessment .....	126

---

<b>E1</b>	Global sourcing .....	127
<b>E2</b>	Make or buy .....	129
<b>E3</b>	Supplier market intelligence .....	132
<b>E4</b>	RFI/RFP process .....	134
<b>E5</b>	Visible process organization (VPO).....	139
<b>E6</b>	Collaborative capacity management.....	144
<b>E7</b>	Supplier tiering .....	146
<b>E8</b>	Value chain reconfiguration .....	148
<b>F1</b>	LCC sourcing.....	151
<b>F2</b>	Bestshoring.....	154
<b>F3</b>	Reverse auctions .....	157
<b>F4</b>	Expressive bidding.....	158
<b>F5</b>	Vendor-managed inventory (VMI) .....	160
<b>F6</b>	Virtual inventory management.....	162
<b>F7</b>	Sustainability management.....	164
<b>F8</b>	Revenue sharing .....	167

---

<b>G1</b>	Cost-based price modeling .....	168
<b>G2</b>	Cost-regression analysis .....	169
<b>G3</b>	Price benchmarking.....	173
<b>G4</b>	Total cost of ownership .....	175
<b>G5</b>	Supplier development .....	177
<b>G6</b>	Total life cycle concept .....	180
<b>G7</b>	Project-based partnership .....	183
<b>G8</b>	Profit sharing .....	185
<b>H1</b>	Linear performance pricing .....	186
<b>H2</b>	Factor-cost analysis .....	188
<b>H3</b>	Unbundled prices .....	189
<b>H4</b>	Leverage market imbalances .....	191
<b>H5</b>	Supplier fitness program .....	192
<b>H6</b>	Collaborative cost reduction .....	195
<b>H7</b>	Value-based sourcing .....	197
<b>H8</b>	Strategic alliance.....	199

---

<b>5</b>	<b>The way forward .....</b>	<b>203</b>
5.1	Application patterns .....	204
	Overview of cross-functional capabilities .....	205
	Core procurement cluster.....	206
	Controlling cluster.....	207
	Globalization cluster .....	207
	Entrepreneurship cluster.....	207
	IT cluster .....	207
	Statistics cluster.....	208
	Manufacturing cluster.....	208
	Engineering cluster.....	208
	Supply chain cluster.....	208
	Corporate strategy cluster .....	209
5.2	Innovative ways of using the Purchasing Chessboard .....	209
	Reverse application, using the Purchasing Chessboard as a creativity tool when developing a commodity strategy .....	210
	Using the Purchasing Chessboard to develop a vendor management strategy for large CAPEX programs .....	211
	Using the Purchasing Chessboard to plan and execute strategic corporate moves .....	211
5.3	Return on Supply Management Assets ROSMA.....	213
	Spend coverage .....	215
	Velocity .....	216
	Category yields .....	216
	Compliance.....	216
	Additional benefits .....	217

<b>Appendix.....</b>	<b>221</b>
<b>About the authors.....</b>	<b>223</b>



# 1 Procurement: the case for clout

Let's get started with a message to analysts: For the benefit of your stakeholders, encourage your corporation to install a heavyweight Chief Procurement Officer (CPO). The case for this is simple. If a company spends between half and two-thirds of its revenue on purchased goods and services, you better have someone with political clout running the show.

Just looking at how well a company—any company—did in the 2008 economic cycle should be a convincing enough argument. Those firms with a CPO equal in rank to the head of sales, head of R&D, or head of production did consistently better than those that relegated procurement to the lower echelons.

## 1.1 It is a jungle out there

Danish physicist Niels Bohr's famous quote, "Prediction is very difficult, especially about the future," still holds true. We can, however, look at undercurrents in today's world and foresee with some certainty the climate in which procurement will need to excel tomorrow.

Having talked to numerous key players in industry and academia, we predict that, if anything, life will get even tougher for procurement. The hey-

day of procurement is over—when relatively simple methods such as tendering, bundling volume, and concluding multi-year contracts yielded 1 to 2 percent price cuts from suppliers per year. It is survival of the fittest at its purest. There are three partially interacting reasons for this:

- Extreme competition
- Extreme volatility
- Quest for sustainability

## **Extreme competition**

The speed at which industries are being shaken up seems to increase exponentially. Just 10 years ago, there were about 15 serious passenger car makers in the world, and industry talk at trade shows and conventions often turned to the number that would remain after consolidation. Five was a popular guess. Today, there are 150 passenger car makers in China alone and even the best auto journalist cannot name all of them.

Chinese firms are also capable of producing domestic appliances at such low cost that their retail price in Europe undercuts the production cost of their leanest European competitor.

Even being the industry leader with scale advantage no longer provides protection. The world's biggest PC maker decided to part from its core business because of deteriorating profit margins. At the same time, another PC maker and a company rooted in online search engines are revolutionizing the mobile phone industry and pushing established players close to the abyss.

In this environment, companies need to amass the troops. Procurement, with its control over a large portion of the revenues and access to a near-endless source of innovation, can provide a lot of muscle.

## **Extreme volatility**

Volatility is today's reality. Almost anything that is breaking news on CNN has an impact on procurement. Foreign exchange rates, sovereign debt crises, rating agency decisions, regime changes—the CPO needs to anticipate and have a response. The increasing volatility facing procurement today is best illustrated by events in the raw materials arena. In early 2008, raw material prices spiked to unprecedented heights—just three years previously, prices had been between half and one-third of that level. At the same time, price volatility was on the rise. In 2005, the average spread between observed minimum and maximum prices throughout the year for a basket of select raw materials was 40 percent, while in 2008 the spread was 163 percent.

Companies were caught off guard by the price hikes, and struggled to defend the attack on profits. Then, by the fall of 2008, in the aftermath of the financial crisis, demand for raw materials dropped drastically and so did their prices. The sigh of relief heard around the world was that of CEOs, CFOs, and CPOs who thought they could return to “business as usual.” Nothing, however, could have been further from the truth. The roller coaster ride of raw material pricing was just beginning.

After hitting rock bottom in the fall of 2008 and early 2009, raw material prices bounced back. During 2010, the three largest iron ore mining companies—Vale, Rio Tinto, and BHP Billiton, which control approximately two-thirds of the seaborne iron ore trade—forced steel suppliers

away from their historic one- to two-year contracts and into quarterly or even monthly contracts. By early 2011, price contracts for coking coal, a key raw material in steel production that had previously been adjusted on a yearly basis, were also being adjusted quarterly or monthly.

Faced with new pricing rules and significant consolidation of the raw material supply base, steel manufacturers looked for ways to reduce their exposure to short-term price volatility and pass the costs on to their customers. The repercussions of these adjustments were felt across many industries. The ability to effectively manage raw material prices and supply has become essential to managing overall company profitability. Addressing these issues on an ad hoc basis—generally the approach taken in the past—is one thing; really grasping and actively managing the full implications of raw material price changes on income and balance sheets is another. Doing the job properly requires substantially upgraded procurement functions.

## **Quest for sustainability**

For decades, the responsibility of a company was largely confined to its production sites. In the 1980s it expanded to include operational environmental protection, and in the 1990s grew further to embrace the concept of corporate social responsibility, largely understood as a company's responsibility to the local community. (This was a time when every company that outsourced had the immediate side benefit of freedom from such responsibility!) Then the corporate responsibility landscape changed again, and these days with every operating license comes a requirement to sign on to sustainability: Any company that wants to succeed needs to play its part in meeting today's environmental, social, and economic challenges. Consumers, activist groups, regulators, and capital markets alike

turn to (and on) global firms in particular, and challenge the ways in which their sourced goods are produced. Consumers increasingly hold companies responsible for infractions that occur along the value chain, and will boycott stores when, for example, they hear news reports of child labor. Stakeholders expect companies to control their value chain as if it were in-house!

Information on the first stages in the value chain isn't easy to acquire. Sustainable procurement policies are, and can only be, a first step, and that's assuming they're even possible, which they may not be. Auditing is necessary for self-reports and transparency is obligatory.

The leaders are ramping responsibility up a notch: In early 2011, sportswear producer PUMA, for example, published an economic valuation of the environmental impact caused by greenhouse gas emissions and water consumption, in preparation for including it in its P&L statement.

## 1.2 Getting more strategic after all

The good news: A recent A.T. Kearney global study finds that most companies are getting the message. The role of procurement is gaining traction in both the development and execution of the business strategy. The not-so-good news: Progress is painfully slow.

### Strategic integration

If a CPO has a role in developing and executing a company's strategy, then obviously the company's strategy will carry over to procurement's goals and objectives. And indeed, we are seeing evidence of this. In gen-

eral, procurement's goals are more likely to reflect corporate priorities—those pivotal to business success such as “develop and access external sources of innovation”—than nice-to-have, procurement-focused preferences such as “reduce the number of suppliers.”

## **Procurement-driven innovation**

Study participants who unrestrainedly tie procurement to strategy development and execution are reaping many more rewards than those who do not. They enjoy higher levels of innovation, and their suppliers play a much more active part in the new product and new service development process. And, they collect the bonus of reduced time-to-market for their new products. The benefits go two ways, with both company and suppliers reaping profits from new business opportunities and revenue streams. As an example, take a look at the mobile handset market. Back in 2005, Nokia was the undisputed leader and Apple wasn't even in the game. In Q1 2011, Apple's mobile handset revenues (iPhone only) were US\$11.9 billion, easily overtaking Nokia's (116 models) US\$9.4 billion.

## **Bottom-line impact**

Even among procurement leaders, the trade has not totally migrated toward a pure top-line focus. Bottom-line impacts are still at the core of every procurement function. In these classic areas, survey participants with strategically integrated procurement are still doing consistently better: Procurement leaders are more likely to improve the overall value for money of purchased goods and services and reduce working capital. The most effective factor? The leaders' tendency to engage actively with other parts of the business and collaborate across functions.

## Organizational setup

Interestingly, the decade-old debate of centralized versus decentralized seems to have run its course, with the overwhelming majority favoring centralized procurement. In this model, procurement is responsible for most of the strategic decision making in most categories. (Local staff may execute the work.) The biggest benefit of the centralized model is the ability to develop a team of experts. Here is a good example:

A leading elevator manufacturer had about 100 people in procurement, dispersed throughout 20 main sites in North America, Brazil, Europe, the Middle East, China, and Korea. In the original setup, the five (on average) buyers per site were responsible for buying everything the site needed. The materials alone accounted for a huge number and a wide variety of mechanical, structural, and electrical components, all spread across different metals. Given such complexity, even seasoned buyers would have no more than a superficial technical understanding of the items. Consequently, the engineers would tend to make all the relevant calls and only involve the buyers for transactional tasks with suppliers. Top management saw that procurement was heading down a dead end road and took it in a very different direction: Six global commodity managers (GCMs) were made responsible for all decision making within their realms. The GCMs lost no time getting a grip on the technologies relevant to their jobs and quickly gained credibility and status with engineering.

## Emerging markets

Procurement leaders are not just more strategically integrated and centralized, they are also more likely to venture out to emerging markets. Despite the debate about whether or not China is becoming less interesting, procurement leaders have substantially increased their sourcing from China over the past couple of years. They also expect to continue doing so for the foreseeable future, but not for the reason you may imagine. For there has been an interesting shift away from low cost as the chief motive—the lure now, increasingly, is the highly skilled manual labor force. (Readers who shop for their furniture at Macy's will see the evidence, the "Made in China" tag that appears on most of the attractive hand-crafted furniture.) Of all the BRIC countries providing highly skilled labor, India shows the most dramatic increase. By contrast, Russia, despite its great potential, is lagging behind and unlikely to catch up any time soon.

## Supply risk management

The procurement leaders think many moves ahead, just in the way a chess grandmaster would do. One car maker, for example, is liaising with NASA's Johnson Space Center to gain access to leading edge, proven risk management concepts. However, the supply chain disruptions that many prestigious companies such as Toyota were struggling with after the tsunami in Japan were a wake-up call for just about everyone in procurement. Although procurement leaders claim to apply most state-of-the-art risk management approaches in relevant categories, during our in-depth interviews with them they conceded that even they are just one natural disaster away from a major business disruption. In general, procurement needs to do a much better job here, and adopt a comprehensive approach that accounts for low probability, high-impact events. Demographic shifts, rising activism,