The Shift to Total Value of Ownership

Moving beyond total cost reduction to value maximisation

Olaf Schatteman – October 2013
Cost reduction is no longer enough – with organisations operating in complex and dynamic markets, more and more is being asked ofProcurement.

In a context of permanent volatility, more and more is asked of procurement.

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We have come a long way on the journey from Price to Value – Best in class procurement functions are adopting a true TVO approach.

Trends in Value Creation

Price Management

Price + Volume

Supply Market Competition

Total Cost of Ownership

Purchase cost
Specifications
Acquisition cost
Ownership costs
Obsolescence costs
Inventory costs

Perceived opportunities
Effective opportunities

Total Value of Ownership

Price
Risk & Sustainability
Usage & Innovation
Process & Working Capital
Value encompasses far more than just price – broader approaches to procurement help organisations to build competitive advantage.

The Total Value of Ownership (TVO) approach fundamentally changes relationships with suppliers from “cost focused” to “driving value”.
Value encompasses far more than just price – broader approaches to procurement help organisations to build competitive advantage

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<tr>
<th>Price</th>
<th>Usage &amp; Innovation</th>
<th>Risk &amp; Sustainability</th>
<th>Process &amp; Working Capital</th>
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<td>Intellicosting</td>
<td>Blockbuster Introduction</td>
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<td>Mega-Supplier</td>
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<tr>
<th>Leverage Competition</th>
<th>Product Design</th>
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<th>Tactical Cost Management</th>
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<td>Cost Data Mining</td>
<td>Value Engineering</td>
<td>Feature/Quality Optimisation</td>
<td>Tax-efficient Procurement</td>
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<td>Buying Group</td>
<td>Standardisation</td>
<td>Index &amp; High Currency Hedging</td>
<td>Contract Optimisation</td>
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<td>Globalisation</td>
<td>Life Cycle Management</td>
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<td>RFx Tendering</td>
<td>Design to Cost / Design to Distribute</td>
<td>Market Driven Decision Making</td>
<td>Contract Compliance Management</td>
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<th>Demand Management</th>
<th>Sustainable Buying</th>
<th>Transaction Process Improvements</th>
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<td>Product / Category Bundling</td>
<td>Substitution &amp; Standardisation</td>
<td>Supplier Sustainability Development</td>
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<td>Speed Sourcing</td>
<td>Preferred Parts Management</td>
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<td>Outsourcing</td>
<td>Smart Consumption</td>
<td>Policy &amp; Regulation Compliance</td>
<td>Invoice Process Optimisation</td>
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Depending on the complexity and criticality of a category, value can be achieved by focusing on the levers that help reduce the purchase price of goods and services.

**Key Price Levers**

1. **Commodity Supply Management**
   - Product Category Bundling
   - Outsourcing

2. **Leverage Competition**
   - Cost Data Mining
   - Buying Group

3. **Supplier Value Creation**
   - Intellicosting
   - Supplier Development
Levers to improve key processes and a prudent use of capital can bring incremental cost savings as well as significant new value through supply chain integration.

### Key Process / Working Capital Levers

1. **Transaction Process Improvements**
   - E-Procurement
   - Requisition to Pay Automation

2. **Tactical Cost Management**
   - Tax-efficient procurement
   - Contract Optimisation

3. **Supply Chain Integration**
   - Supplier Process Collaboration
   - Make or buy equilibrium
   - Distribution and Warehouse optimisation
Usage and innovation levers can be applied to control cost by managing demand, in addition to optimising product design and encouraging innovation with suppliers.

**Key Usage / Innovation Levers**

1. **Demand Management**
   - Substitution and Standardisation
   - Preferred Parts Management
   - Smart Consumption

2. **Product Redesign**
   - Value Engineering
   - Standardisation
   - Lifecycle Management

3. **Supplier Collaboration**
   - Collaborative R&D
   - Supplier Driven Cost Optimisation
Leaders are moving into more collaborative relationships with their suppliers and are reporting incremental performance improvements

Trends in Supplier Performance Management

<table>
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<th>Starting point</th>
<th>Current best practice</th>
<th>Emerging trend</th>
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<tr>
<td><strong>Rationalise Supplier Base</strong></td>
<td><strong>Collaborate with Strategic Suppliers</strong></td>
<td><strong>Broaden your creativity</strong></td>
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</table>
| Rationalising Supplier base is a consistent approach to identifying suppliers based on the commercial business needs | Collaboration with Strategic Suppliers focuses on the alignment of values and scorecards to measure relationship performance.  
- break down the barriers between strategic suppliers and Customer  
- enable Suppliers to increase the value to the company | Broaden your Creativity focuses on the alignment of values and balanced scorecards to a larger pool suppliers.  
- break down the barriers between transactional, tactical and strategic suppliers and the client  
- enabling suppliers to increase the opportunities and value to the company |
| • Long tail of suppliers analysed  
• Opportunities identified to improve leverage of spend  
• Improved visibility of key supplier base | • Key suppliers segmented  
• Tier one suppliers tightly managed  
• Roadmap plans shared & influenced by customer | • Use broader eco-system of supplier’s for idea generation and collaboration  
• Use of different management engagement for different suppliers.  
• Focussed and measured integration with strategic suppliers. |

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Organisations can minimise environmental impacts and improve brand value by focusing on sustainability levers, and can focus on reducing market risks to secure supply.

Key Risk / Sustainability Levers

1. **Sustainable Buying**
   - Supplier Sustainability Development
   - Green Sourcing
   - Policy and Regulation Compliance

2. **Market Risk Management**
   - Feature/Quality Optimisation
   - Index and High Currency Hedging
   - Market Driven Decision Making

3. **Supply Risk Management**
   - Joint Planning
   - Predictive Analytics
The category approach and value levers selected are driven by three key elements:

- Total Value of Ownership explained
- Choose level of strategic ambition by element

What drives your strategic intent?

- More sophisticated
- Focus on long term
- Integrate across organizations

- Quick to implement
- Minimal resources
So why does it not work ...

Many companies struggle to recognise the value of their procurement function

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<tr>
<th>Procurement Value Killers</th>
<th>Common Themes</th>
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<tr>
<td>Governance</td>
<td>• Collaboration &amp; escalation are not implemented/respected</td>
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<td></td>
<td>• Not a discussion of equals</td>
</tr>
<tr>
<td>Capability &amp; reach</td>
<td>• Size and competence</td>
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<td></td>
<td>• “Go between” supply market and internal customers</td>
</tr>
<tr>
<td>Spend = P * V</td>
<td>• Part control: Total spend – Price * Volume</td>
</tr>
<tr>
<td></td>
<td>• Demand &amp; specifications management</td>
</tr>
<tr>
<td>Execute</td>
<td>• Sourcing is step 1 – followed by contract deployment and operational management</td>
</tr>
<tr>
<td></td>
<td>• Reliable service operations</td>
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Price, Process & Working Capital focus on extracting cost from existing Operations

The traditional focus in the first two levers is typically on rapid and reliable initiatives to extract cost from current operations initially.

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Focus of these approaches

- **Deep Sourcing**
  - Product design
  - Supplier Collaboration

- **Strategic Sourcing**
  - Strict methodology, TCO based, X-functional teams
  - Thorough internal/external analysis
  - Request for Proposal
  - Implementation planning and Savings Management

- **Speed Sourcing**
  - Price Alignment
  - Supplier Rationalisation
  - Volume Consolidation
  - Request for Quotation
  - Auction

- **Basic Procurement**
  - Spot Buying
  - Consumption Control
  - Simple Price Requests
  - Contract Coverage & Compliance

- **Benefits/Cost Ratio**

- **Time (months)**
  - 0
  - 2
  - 4
  - 6
  - > 6

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As traditional avenues for cost reduction are exhausted, Procurement must focus on creating top line value in addition to achieving bottom line savings.

Procurement has traditionally focused on cost savings and process improvements that impact the bottom line, with very little impact on sales and revenue.

By adopting a TVO approach and focusing on innovation, risk and sustainability in addition to price, process and working capital, procurement can also impact the top line.
It is only through greater collaboration between business users and procurement that all value levers can be utilised effectively and greater value realised.

**Procurement Value Levers**

- **Price**
- **Process & Working Capital**
- **Usage & Innovation**
- **Risk & Sustainability**

The arrows indicate the increasing level of business involvement across the 4 elements, with Price requiring the least stakeholder input.

**Common Themes**

1. **From cost focus to driving value:**
   - Closer collaboration with business partners
   - Category management and focus on strategic activities

2. **Procurement as a business enabler:**
   - Joint planning and target setting
   - Value tracking and pro-active cost avoidance

3. **Operational efficiency and excellence:**
   - Homogenous processes across countries
   - Efficient P2P process
TVO in practice – utilities organisations have been generating revenue through sustainability and innovation
TVO in practice – telecommunications companies are generating revenues and strengthening presence in new customer markets through innovative app development
TVO in practice – A leading consumer goods expects suppliers to be its key source of innovation
TVO in practice – procurement teams are working closer with engineering and R&D teams to find more ways of optimising product design to drive further value.
Using a TVO framework provides an innovative vehicle to expand the definition of procurement value, and to bridge the gap between procurement and finance.

\[
\text{TVO} = \frac{\text{Value (\$) delivered to the business from procurement}}{1,2,3,4} - \frac{\text{Costs (\$) of procurement}}{1,2,3,4} \quad \frac{\text{Value of Procurement}}{1,2,3,4} - \frac{\text{Value of Risk & Quality}}{1,2,3,4} - \frac{\text{Value of Sustainability}}{1,2,3,4} - \frac{\text{Value of Innovation}}{1,2,3,4}
\]

\[
\text{Normalization Factor (Revenue or Profitability)}
\]

- **C1) Costs ($) of procurement**
  - People
  - Technology
  - Admin
  - Infrastructure

- **C2) Costs ($) of risk & quality**
  - Supply volatility
  - Conversion process uncertainty
  - Demand stability
  - Financial volatility
  - Regulatory volatility
  - Quality

- **C3) Costs ($) of sustainability**
  - Environmental
  - Human rights
  - Safety practices
  - Social responsibility
  - Training

- **C4) Costs ($) of innovation**
  - R&D
  - People
  - Supplier capacity
  - Technology
  - Marketing
  - Other implementation costs
Future success will be achieved by those who ensure their procurement brand compulsively contributes to value for the entire organisation

- **Permanent volatility**: more and more is being asked of procurement

- External market factors pushing to **new era of procurement** – deliver more than just cost reduction

- Companies are succeeding in a TVO approach by ensuring procurement staff are skilled in supplier collaboration and innovation, as well as staying focused on risk and commodity management

- **Embedding procurement staff** in engineering, quality and R&D departments can improve visibility and ensure early project engagement