Category Management - Strategic Sourcing

Dave Porter
What is Procurement Category Management?

• Category management is a process which relies on cross functional teamwork to generate procurement outcomes that fully satisfy agreed business needs.
  – Categories group products and services together based on the ability of the market to supply not on the basis of organisational boundaries.
• BUT - this has been the goal of the procurement profession for many years – what is so special about category management?
  – Extent of engagement and teamwork with stakeholders for all expenditure with suppliers.
    • Not simply allocating categories/commodities to procurement team members
  – Governance process which crosses organisation boundaries.
  – Depth of category specific knowledge and expertise – market & technical.
  – Emphasis on planning and use of analytical tools.
The Planning Issue

Agreement/Contract

Re-active
- Expediting
- Problem Solving
- Receiving
- Inspection
- Excessive Contract Supervision
- Storing
- Invoice Matching
- Handling Emergencies!

Upstream
- Need
- Specification
- Enquiry

Available Resource (time)
- 20%

Downstream
- 80%
The Planning Solution

Pro-active

- Business Objectives
- Supply Planning
- Market Analysis
- Supplier Management
- Tender Improvement
- Strategic Plans
- Contract Strategy
- Negotiation

Agreement/Contract

- Receive Goods & Services
- Manage Performance & Pay

Category Management helps invert the triangle

Available Resource (time)

Upstream

- 80%

Downstream

- 20%
How do I define Categories?

You should group commodities together so that category groups comprise:

1. Commodities that have similar functional characteristics and........
2. Reflect supply market capability.
Category Management Process
Key Components

- Establish team & governance structure
- Gather data & analyse - internal & market
- Identify & quantify opportunities
- Develop procurement strategy options
- Implement preferred procurement strategy

Comprehensive category plans addressing all sub categories

Specific strategy for procurement of one or more sub categories

Category plan identifies all opportunities within a category along with the anticipated means of achievement. For simple procurement, it may also define the procurement strategy.

Low value simple procurement may simply involve implementation of the conclusions of the category strategy e.g. use a collaborative framework/contract, change the specification and re-negotiate terms.

More detailed investigation is required for high value complex procurement. This is often referred to as Strategic Sourcing or Procurement Strategy.
Strategic Sourcing Process & Tools

- Membership
  - Clear Objectives

- Establish multi-functional team

- Understand current supply arrangements

- Market Analysis

- Business Needs

- Strategy Development

- Preferred Procurement Strategy

- Implementation

- Contract Management

- Review

- Lessons learnt

- RFP / RFQ / Negotiation
  - EU Procurement Process
    - Select Procedure
    - Selection & award criteria
    - Contract Notice
    - Supplier selection
    - Tenders and assessment
    - Negotiation plan where appropriate
    - Contract documentation
    - Contract management plan
    - Contract award

- What is being purchased, why and how
  - Existing Suppliers
  - What works well
  - Problems/issues

- What the business really needs
  - Technical/Functional Spec

- Confirm Business Needs
  - Option Analysis

- Select preferred Option
  - Implementation Planning
  - Detailed Business Case
  - Endorsement to implement

- Delivery Management
  - Relationship Management
  - Contract Administration
  - Continuous Improvement

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Strategic Sourcing - A Case Study
Historic Position

- A number of organisations bought milk individually or in small groups for their customers.
- Fairly wide range of existing suppliers encompassing national, regional and local suppliers
- Milk was delivered on a daily basis in the morning.
- Customers were happy with the service provided but all organisations were under significant pressure to reduce cost.
- Organisations sought to reduce cost through collaboration.
Current Position

- Organisations aggregated demand within a framework for milk.
- Framework was divided into fairly large geographic lots with tenderers able to tender for any lot.
- Customers wished to retain the same service (daily delivery by 10am) with all ideally paying the same price.
- Customers were unwilling to accept less frequent delivery due to limited back room storage.
- Customers’ wishes became the objectives for the procurement.
Review of Current Strategy - Positioning and Preferencing

Establish multi-functional team

Understand current supply arrangements

Market Analysis

Assumed Current Position

Positioning of purchase (milk - category)

<table>
<thead>
<tr>
<th>Risk</th>
<th>Strategic Security (Secure Supply)</th>
<th>Strategic Critical (CI Relationship)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tactical Acquisition (Min Acquisition Cost)</td>
<td>Tactical Profit (Leverage market)</td>
</tr>
<tr>
<td></td>
<td>Milk</td>
<td></td>
</tr>
</tbody>
</table>

Preferencing of Client by Primary Supplier

<table>
<thead>
<tr>
<th>Attractiveness</th>
<th>Development (Grow business)</th>
<th>Core (Keep business)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nuisance (Off-load)</td>
<td>Exploitable (Short term gain)</td>
<td></td>
</tr>
</tbody>
</table>

Relative Value of Business - % T/O

Tactical Profit Strategy Pursued

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What actually happened?

• Large national supplier won all but one lot, which was won by a large local supplier.
• A few organisations then withdrew from the framework to run smaller more local competitions.
• Service delivered successfully but prices are little different to those previously paid.
• Local competitions delivered prices a little below the framework prices.
• Requirement to deliver small volumes to all locations by 10am each day effectively reduced the market to one supplier (primary supplier).
• Primary supplier was being investigated by OFT for price fixing along with supermarkets and other large dairy suppliers.
Financial Analysis - Primary Supplier

2008 and 2009 (ending April 2009) Accounts

• Mission - To become the largest and most respected liquid milk processing group in the UK
  – already supply 25% of UK market
  – UK demand rising but production falling as farmers move out of dairy

• Motto - strength through partnership
  – The Milk Partnership - 830 farmer partners from whom the bulk of milk is purchased
  – sets farm gate prices
  – remainder of milk sourced from other dairies
### 2008 and 2009 Accounts

<table>
<thead>
<tr>
<th></th>
<th>2009 £000</th>
<th>2008 £000</th>
<th>% Change</th>
<th>Comments in Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales/Turnover</td>
<td>847702</td>
<td>721983</td>
<td>+17.4%</td>
<td>T/O up every year since 2004 and vol of milk increased by 6.3% 400m litres p.a. To Tesco (50% own brand) - similar deals with Sainsbury, Somerfield, Co-op &amp; Spar. Has 25% of UK milk market.</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>667309</td>
<td>551829</td>
<td>+20.9%</td>
<td>Profitability declined in first part of 2009 but recovered in second half by cutting farm gate prices by about 10% in Feb 09</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>180393</td>
<td>170154</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Profit as % of Sales</td>
<td>21.3%</td>
<td>23.6%</td>
<td>-9.7%</td>
<td>Operating margin per litre of 2.17p with farm gate price of 25.02p post Feb 2009. Farm gate price is benchmarked against others but no mention of price farmers might need.</td>
</tr>
<tr>
<td>Admin Expenses</td>
<td>146256</td>
<td>139431</td>
<td></td>
<td>Aggregated demand is almost 1% of the supply capacity of the primary supplier.</td>
</tr>
<tr>
<td>Other Operating Income</td>
<td>1010</td>
<td>922</td>
<td></td>
<td>What procurement strategy is being pursued by the Primary Supplier through the Milk Partnership?</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>35147</td>
<td>31645</td>
<td>+11.1%</td>
<td>Strong</td>
</tr>
<tr>
<td>Operating Profit as % of Sales</td>
<td>4.1%</td>
<td>4.4%</td>
<td>-6.8%</td>
<td>Strong with small stock</td>
</tr>
<tr>
<td>Profit before Tax (after deduction of investment income and finance costs)</td>
<td>30767</td>
<td>29184</td>
<td>+5.4%</td>
<td></td>
</tr>
<tr>
<td>PBT as % of Sales</td>
<td>3.6%</td>
<td>4.0%</td>
<td>-10.2%</td>
<td></td>
</tr>
<tr>
<td>ROCE (PBT as % of Capital Employed)</td>
<td>7.2%</td>
<td>7.0%</td>
<td>3.2%</td>
<td></td>
</tr>
<tr>
<td>Current Ratio</td>
<td>2.88</td>
<td>2.89</td>
<td>-0.3%</td>
<td></td>
</tr>
<tr>
<td>Liquidity Ratio (after deduction of Inventory &amp; WIP)</td>
<td>2.78</td>
<td>2.8</td>
<td>-0.7%</td>
<td></td>
</tr>
</tbody>
</table>
## Purchase Price and Cost Analysis - Primary Supplier

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
<th>Source/Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avg Operating Profit as % of Sales</td>
<td>4.25%</td>
<td>Calculated from Profit and Loss account</td>
</tr>
<tr>
<td>Avg operating profit (pence per litre)</td>
<td>2.17p</td>
<td>Quoted in accompanying statements to the accounts</td>
</tr>
<tr>
<td>Avg sale price (pence)</td>
<td>51.1p</td>
<td>Calculated from above data</td>
</tr>
<tr>
<td>Actual avg price paid through framework (pence per litre)</td>
<td>70.0p</td>
<td>Paid through framework awarded</td>
</tr>
<tr>
<td>Potential premium paid (pence per litre)</td>
<td>18.9p</td>
<td>Large difference but multiple outlets, some in remote places with difficult logistics</td>
</tr>
<tr>
<td>Farm gate price (pence per litre)</td>
<td>25.02p</td>
<td>Quoted in accompanying statements to the accounts</td>
</tr>
<tr>
<td>Avg supplier processing, distribution and overhead costs (pence per litre)</td>
<td>23.91p</td>
<td>Calculated from above data - processing and overhead costs are fairly fixed</td>
</tr>
</tbody>
</table>
| Actual distribution costs (pence per litre)                 | ???    | Possibly an additional 18.9p per litre???
Using Positioning and Preferencing Effectively

Assumed current position - positioning (milk) and preferencing (by Primary Supplier)

More likely actual current position - positioning (milk) and preferencing (by Primary Supplier)
The Business Needs and Strategy Development

- But the Business Needs were set at the start.
  - Daily early morning delivery of fresh milk to all locations at the same price

- Should the Business Needs be adjusted to reflect what we now know about the market?
Modified Business Needs and Strategy Options

• Milk has a shelf life of up to (say) 8 days
  – Do we need daily delivery - constraint is lack of back room storage
  – What if we stored the milk in the front room - how could it be done?
  – Do we need to store the milk in small separate containers?
• What might happen if the need was expressed as:
  – Most cost effective provision of a specified volume of milk to each customer
    at each location by 10am on a daily basis subject to no backroom storage.
• Milk suppliers may still offer daily delivery
• Dispensing services suppliers might provide and service vending machines in the
  front room with less frequent deliveries for the more remote and smaller locations
• Vending machines could dispense other products, potentially generating sales
The News

Dec 2007 - OFT welcomes early resolution agreements and agrees over £116m penalties regarding collusion between supermarkets and dairy suppliers incl the primary supplier. Legal proceedings subsequently dropped.

Nov 2009 - Primary supplier first half (April to Oct 2009) profits leap by 81%.

Sept 2010 - Primary supplier issues profit warning - intense competition and rising plastics (oil related) costs are blamed.

March 2011 - Primary supplier warns of higher prices driven by higher input prices including 2 increases in 2 months (up 8%) to farmers. Vows to push for higher price from supermarkets.

May 2011 - Competition hits primary supplier profits which are down 30% - all major retailers had put milk contracts out to tender and that had increased competition and squeezed margins although volumes had risen as a result.

Jan 2012 - Primary supplier agrees to takeover by major European dairy at 60% premium on current share price and 25% discount on 2010 high. By this time, primary supplier has 30% of UK milk market.

How quickly things change - plans must be kept up to date
For more information on Category Management or Strategic Sourcing
please contact Dave Porter
dave.porter@pmms-group.com