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“Shaping new products through early involvement, bringing outside perspectives to better design a company’s value chain, or fully managing a company’s outsourcing network—the expectations for CPOs are rising constantly. *Procurement 20/20* compellingly explains what CPOs should expect, and how they can shape the future.”

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“*Procurement 20/20* provides valuable insights into the impact globalization and volatility will have throughout the value chain. Leaders will benefit in understanding how these factors and others will shape their sourcing strategies today and into the future.”

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“In today’s fast changing world, managing to a benchmark is important but simply not enough. Future development and trends have to be anticipated and management adjusted accordingly. In this spirit *Procurement 20/20* is an excellent resource for any CPO. It provides compelling visions for the future of the function and hands-on solutions for a challenging business environment. A must read!”

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“*Procurement 20/20* looks beyond the classical sourcing tasks and explores how to establish strategic business models with the supply base, reduce risks, and drive growth to create more value along a company’s full value chain. An inspiring thought-piece for any procurement professional.”

—Albie van Buel, CPO, Vestas Wind

“We aspire to mastering all opportunities offered by the rapidly changing marketplace, and this book provides an excellent road map for the journey that lies ahead of us.”

—Hans Melotte, Vice President and Chief Procurement Officer, Johnson & Johnson

“*Procurement 20/20* takes a bold look into the future and explores the changes that the procurement function needs to make. It is a must read for the ambitious CPO.”

—Babara Kux, Member of the Managing Board, Siemens AG
“The next decade will require the procurement function to better understand the dynamic and volatile world, particularly where sourcing strategies must be flexible and creative to operate in a global footprint. This book provides the CPO and the procurement team with several provocative trends that will shape the coming years, and a structured road map to address the opportunities.”

—Luiz Lissoni, Vice President of Supply Chain, Brasil Foods

“Procurement 20/20 is an inspiring invitation to stop and reflect on the ‘new normal’ for procurement. And it sends a clear message to CPOs: It’s time to get ready for the next decade!”

—Bertrand Conqueret, CPO, Henkel

“This book explores very convincingly how CPOs and their organizations need to adapt to deal with the challenges of the future.”

—Vicente San Miguel, Chief Procurement Officer, Telefónica

“A highly inspiring book: The strategic insights draw the necessary change agenda for all CPOs. It is written in a most engaging style, provides numerous examples relevant to today’s world, establishes the burning platform, and outlines the key elements that the new procurement agenda must address. If there ever was a book to motivate the CPO to action, this is it!”

—Alan Hustwick, CPO, Pacific Aluminium

“Today’s global megatrends make the strategic side of procurement increasingly vital for the success of any business, from strategic supply management to sourcing innovation. A revealing book on supply entrepreneurship.”

—Paul van Attekum, EVP Supply Management, ASML

“A must-read for practitioners and academics alike.”

—Christian Terwiesch, Andrew M. Heller Professor at the Wharton School of the University of Pennsylvania
Procurement 20/20
Procurement 20/20

Supply Entrepreneurship
in a Changing World

PETER SPILLER
NICOLAS REINECKE
DREW UNGERMAN
HENRIQUE TEIXEIRA

WILEY
## Contents

- **Preface**  ix
- **Introduction: The Procurement Advantage** xiii

### PART 1 FROM GOOD TO GREAT PROCUREMENT 1

#### CHAPTER 1 The Drivers of Sustainable Procurement Performance  3

Procurement pays. Yet there is no free lunch in obtaining procurement excellence. The best companies pay for talent, and advanced procurement tools and strategies become essential to achieve cost savings. Long-term success can lead to a strategic role for procurement teams and a seat on the board for CPOs.

#### CHAPTER 2 The Megatrends That Impact Competitive Advantage  15

Five megatrends are impacting virtually every company doing business in the global economy—in particular, the procurement strategies of those companies. Do you know what those megatrends are and how they will touch you? If not, read on. Reacting and adapting to these megatrends will be essential to procurement flexibility and competitive advantage by the end of this decade.

### PART 2 RESPONDING TO THE MEGATRENDS OF THE NEXT DECADE 29

#### CHAPTER 3 The Great Global Rebalancing: Building a Dynamic Sourcing Footprint  31

Sourcing-footprint decisions have a short half-life. They have to accommodate everything from best-cost suppliers to regulatory challenges and unprecedented risks. Trickier still is that the relative influence of these factors changes constantly. Are you ready to respond dynamically? And in doing so, can you help other functions advance their own global footprints?
CHAPTER 4  The Productivity Imperative: Orchestrating the End-to-End Value Chain

Successful companies seamlessly manage their end-to-end value chain and tightly orchestrate a network of internal functions and external providers to best serve their customers. What role is procurement playing in this game? How can you take the pivotal orchestrator role?

CHAPTER 5  Big Data and the Global Grid: Procurement’s New Role in Data-Driven Decision Making

Two related developments—big data and the global grid—are combining to dramatically alter procurement’s possibilities. Sitting right on top of the various data streams between the company and its external vendors and partners, procurement must find ways to analyze, structure, interpret, and apply the abundance of data on markets and suppliers to decision-making problems. How are you preparing to seize the resulting opportunities?

CHAPTER 6  Volatility as the New Normal: Translating Sourcing Risk into Competitive Advantage

Procurement operates amid growing volatility and persistent uncertainty. To protect against—or even benefit from—this challenging context, leading organizations are becoming agile. What does this mean in practice? And how can procurement use agility to create a competitive advantage?

CHAPTER 7  The New Economic Drivers: Capturing the Total Impact of Environmental, Social, and Regulatory Factors

Environmental, social, and regulatory considerations are poised to become key decision-making variables for CPOs as they select suppliers of goods and services. What are some of the innovative solutions that leading procurement organizations are experimenting with in order to cope?

PART 3  THE ROAD MAP TO PROCUREMENT 20/20

CHAPTER 8  Getting Ready for Real Change: Steps for Starting the Journey toward Procurement 20/20

Going for Procurement 20/20 is a stretch aspiration. If you are up for it, your successful transformation should place equal emphasis
on two elements: your company’s business performance and its organizational health. It’s a tricky balance to strike. Discover how to do it.

CHAPTER 9 Your Agenda Now

Seizing the opportunities we’ve discussed means moving from supply management to supply entrepreneurship. The time for visible and tangible action has arrived. What’s your plan of action?

About the Authors

Acknowledgments

Index
For decades, McKinsey & Company has worked with clients to improve their procurement practices and achieve distinctive and sustainable impact. We have averaged more than 250 engagements per year and served chief procurement officers (CPOs) from Fortune 100 companies and start-ups alike. Those companies have come from industries ranging from automotive and assembly, chemicals and basic materials, electronics and high tech to energy, banking, and other services. Many of them have been long-standing clients, served on a broad range of strategic and operational topics, and a large share we have been advising at different procurement inflection points over time: when a new CPO came on board, a merger required significant synergy contributions from procurement, a general reorganization offered the opportunity to strengthen the central procurement governance, or when new sourcing markets had to be explored.

In working with our clients on these engagements, we have been exposed to the most important questions faced by CEOs and CPOs around the world—such as how do we develop cutting-edge sourcing strategies, exploit favorable market conditions, and optimize supply chains to reduce cost across the value chain? How do we build a base of external suppliers that give us the first access to their proprietary innovations so that we can jointly develop the products consumers want, more profitably and more quickly? How do we manage a vast and complex network of suppliers and contract manufacturers to ensure constant supply in a world where supply chains are globalizing, lengthening, and susceptible to more volatility? And how do we make our procurement practices robust enough to avoid the increasing scrutiny of environmental, safety, and regulatory demands, magnified by vastly different expectations from a diverse set of consumers and governments?

This book shares the hard-earned insights from more than 10 years of dedicated procurement research conducted with leading academic institutions and practical experience with marquee clients in the field of procurement and is the natural successor to the many articles we have published on the topic. As such, we’ve attempted two things with this book: to explain and codify the best practices that leading companies
have pioneered in procurement and to frame how procurement must evolve to grapple with new global, social, and economic issues affecting business over the next decade. We wanted it to be as forward thinking and strategic as you’ve learned to expect from our publications, yet practical enough to spark a conversation between a CEO and CPO about the near-term actions their procurement organizations must take to stay ahead in the new world. And while this book is focused on procurement, any company executive—from CEO to COO to CPO—will find relevance in our discussion of the five major megatrends that will impact every function across the business.

Why are we devoting an entire book to procurement excellence today and how it must evolve to be ready for tomorrow? We look at procurement’s past evolution for an answer. In his 1983 article “Purchasing Must Become Supply Management,” our former colleague Peter Kraljic noted, “A decade ago, any chief executive who was losing sleep over his company’s procurement function might be thought to have had his priorities wrong. Today, the likelihood is that he is simply more alert than his competitors to the new and potentially dangerous strategic dimension that materials sourcing has taken on.” As a result, Kraljic argued, procurement must transition from a tactical, operational mind-set to one that is strategic and fully integrated with other key functions in the business.1 Even back then, Kraljic argued that procurement could deliver significant impact by responding to the increasing risks of resource depletion and raw-material scarcity, intensified competition, political turbulence and government intervention in supply markets, and accelerating technological change. In fact, the past 10 years have provided a natural conclusion to what Kraljic predicted: The digitalization of information spread the news of the 2008 Lehman Brothers bankruptcy in seconds, causing world stock exchanges to plunge simultaneously and putting companies out of business; the 2011 Japanese earthquake and tsunami sent reverberations across global supply chains; and the 2010–2011 Arab Spring resulted in instability and speculation across the most oil-rich region in the world. The decade ahead will be no less tumultuous, and procurement’s role will be more important than ever before in maintaining constant supply, best cost, reduced volatility, faster and improved innovation, and positive corporate-brand image. Our purpose is to take Kraljic’s view deep into the twenty-first century by describing the next step in the evolution, the step in which supply management must become supply entrepreneurship.

Toward that goal, we have brought to bear our insights, which have, time and again, proven their entrepreneurial and strategic effectiveness as

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our external partners compete in the global economy. We have drawn on more than 1,500 global procurement studies from the past five years that optimized in excess of U.S. $200 billion of spend, examinations of more than 700 procurement organizations, and 2,000 hours of interviews with CPOs and their staffs across every industry to determine the key dimensions of procurement excellence and its link to corporate performance. The research presented in this book is unique because of the challenges inherent in measuring the success of a single company function. Enlisting top academic institutions, we have developed a framework to isolate the performance and impact of a single business function and to evaluate its impact with a very high confidence level using partial least squares (PLS) statistical methods and multiple-level blind interviews. This framework is, in our view, unrivaled in its detail and provides essential insights for other organizations seeking to remain competitive into the future. The McKinsey Global Institute, our business and economic research arm, has partnered with our strategy practice to identify the five fundamental megatrends that will shape the next decade and beyond. On the basis of the implications of these megatrends, we have tapped into our global network of C-suite officers across leading companies to help define how procurement must evolve. And finally, we've drawn on our organization practice to provide practical advice on how to accomplish transformational change—from defining the aspirations to executing them so that they become part of your function's DNA.

Numerous executives and companies were involved in the development of this book. In particular, we would like to thank the more than 700 clients who took part in our Global Purchasing Excellence survey and served as the inspiration behind the disguised case examples that bring to life the concepts in this book. We would also like to thank the many CPOs who have shared their insights on the book's content during roundtables and conferences and on a one-on-one basis, ensuring it is simultaneously inspirational, relevant, and actionable.

Hindsight is 20/20, and in 10 years, we'll have the benefit of knowing much more than we do today. And at that point, our hope is that you might be browsing your library or your tablet and thinking, “I'm glad I read this.”

Let the journey to Procurement 20/20 begin.

Peter Spiller
Nicolas Reinecke
Drew Ungerman
Henrique Teixeira

McKinsey & Company
Purchasing and Supply Management Practice
Introduction: The Procurement Advantage

It is becoming more and more important for every senior executive to know how to manage the external parts of the company’s value chain.

The evidence is all around us. Look at the news headlines and the experiences you or others in your organization have faced in recent years. Natural disasters and scarcities of raw materials have exacerbated volatility in supply chains, disrupted operations, and caused significant swings in input pricing. As one example, Honda had to weather a tripling of its raw material index between 2009 and 2012; was hit hard by the tsunami in Japan and floods in Thailand, causing a 59 percent profit drop; and has to deal with business-endangering materials scarcity, for example in some specific rare earths like lanthanum. External functional specialists—contract manufacturers and third-party logistics providers, to name just two categories—have proliferated, in both the developed and the emerging worlds, and they regularly deliver new levels of innovation and efficiency up and down the value chain. And yet increasingly stringent ethical, social, and governmental requirements mean that if those specialists have a slipup, it can spoil the brand image of the company whose procurement organization is sourcing from them.

The data further prove the point. Across all the companies listed in Standard & Poor’s 500 stock index, external spend as a fraction of total cost has increased by an average of 40 percent since 1970. Specifically, it has grown from roughly 60 percent of a company’s total expenditure in 1970 to an average of 85 percent in 2010. This is true across sectors as disparate as health care, industrials, banks, and energy. Looking at external spend as a fraction of total revenues reveals the same trend: an increase of more than 30 percent over the past 40 years.

In parallel with this increase of external spend, the employees of those companies have been expected to deliver more. In 1970, companies on the S&P 500 were realizing $40,000 in revenues per employee (RPE). That value has risen almost 22-fold, to roughly $900,000 per employee. Seems like a radical shift? Absolutely. And yet this radical shift is not a one-off
occurrence—it is seen across both successful and trailing industries, and industry leaders and laggards alike. Take information technology (IT) industry giant Apple, which brought in roughly $1,700,000 in revenues per employee in 2011, despite hiring an astounding 30 percent more employees in just the previous year. While seemingly much higher than fellow player Hewlett-Packard (HP), at $360,000 RPE, HP’s RPE has increased a whopping 17-fold since 1970, showing the same focus on greater employee efficiencies. Dow Chemical Company, FMC Corporation, and DuPont, all diversified chemicals players, saw increases in RPE of from 16-fold to 29-fold. Even struggling industries, like automotive, saw companies like Ford bring in over $800,000 per employee, for a 24-fold increase.

The implication is clear: The ways in which the procurement function manages its external spending can confer enormous competitive advantage.

In fact, our research demonstrates that best-practice procurement consistently lowers costs, freeing funds for growth initiatives. Our seven-year Global Purchasing Excellence (GPE) survey of more than 700 companies, across every sector, found that, in total, the participating companies generate U.S. $84 billion in annual cost savings every year. GPE participants were divided into three groups—leaders, average performers, and followers—on the basis of their average overall performance across the criteria in the survey. The leaders not only generated higher cost savings from procurement—30 percent more than average performers—but they also performed better against a broader set of indicators, reducing their cost of goods sold four times faster and achieving higher overall returns from operations. The procurement followers have the highest potential for improvement: Catching up with the leaders would more than double their annual cost savings. The research also shows that opportunities for leveraging procurement exist in all industries—in fact, performance differences among companies in the same industry were much wider than differences among whole industries. Even in industries known for their weak procurement practices, such as financial institutions and utilities, we have found strong procurement leaders that stack up to the best automotive leaders.

The call to action is all too clear. CEOs must hold their chief procurement officers (CPOs) accountable on two levels. CEOs have to demand programs that, in short order, bring procurement practices much closer to those of today’s top performers, focusing on traditional levers to achieve significant cost savings and performance improvement. And they must look to their CPOs to successfully exploit the value offered by a growing external supply base, in the context of the opportunities and risks of the decade to come. The issue in both cases is timing—any transformation, and in particular a cross-functional transformation, takes time to achieve because each one requires a mind-set change by a broad set of employees.
And actions must be taken soon. For many companies, the world is changing uncomfortably fast. A few snapshots: Google—not long ago just a convenient web search-engine company—has taken technology to the next level by pioneering the driverless car, which has the potential to revolutionize the auto industry and transportation infrastructure. In 2011, Latin American and Eastern European companies opened more outsourcing facilities than were opened in India, capitalizing on the time zone and multilingual opportunities to service North American and European customers, respectively. The U.S. government debt has surpassed $16 trillion as public policy expands to provide wider social safety nets and universal health care. And the Libyan revolution sparked a mad dash for power over oil reserves, even though that nation accounts for only 2 percent of the world’s oil supplies.

As disparate as these occurrences might seem, they all have significant implications for how the field of procurement must evolve to lead—in an entrepreneurial spirit—in this new world. Are CEOs and CPOs discussing these implications? More important, are they ready for them?

This book is designed to help inform and enrich those conversations—and in some cases to initiate them. Here is a quick overview of each chapter and its purpose:

Chapter 1, “The Drivers of Sustainable Procurement Performance,” dives into the four key dimensions of procurement excellence we uncovered through our GPE survey. This is essential reading for CPOs who want to understand how their organizations stack up against these foundational elements and who welcome practical advice for how to close the gap with the best practices described.

Chapter 2, “The Megatrends That Impact Competitive Advantage,” showcases the five megatrends that will change the way business is done in the next decade. It draws heavily on research from the McKinsey Global Institute and our Strategy practice. This chapter should have a profound impact on how every senior executive thinks—not only about the company’s procurement function but also about its entire operations, sales and marketing, IT, and external-relations activities.

Chapters 3 through 7 form the heart of the book and constitute its second major part, “Responding to the Megatrends of the Next Decade.” Each provides a detailed exploration of the profound impact of one of the megatrends that will have a major impact on companies as a whole and on procurement in particular. Throughout, we provide strategies that business leaders can adopt in the face of these trends, together with practical advice about next steps and case examples for inspiration. Chapter 3,
“The Great Global Rebalancing,” explores the implications of the rise of developing economies and especially how Western companies need to adapt by building a dynamic sourcing footprint. Chapter 4, “The Productivity Imperative,” illustrates how companies can create productivity gains by designing and orchestrating their business as an end-to-end value chain, consisting of internal and external parties. Chapter 5, “Big Data and the Global Grid,” highlights the opportunities presented by superior, data-driven decision making at the interface to a company’s supply base. Chapter 6, “Volatility as the New Normal,” explains how companies can translate sourcing risk into competitive advantage. And finally, Chapter 7, “The New Economic Drivers,” explores how sourcing decision-making processes will have to increasingly reflect environmental, social, and regulatory factors.

Our final part, “The Road Map to Procurement 20/20,” is designed to prepare your procurement organization for the changes that the preceding chapters have indicated are necessary. These chapters, “Getting Ready for Real Change” and “Your Agenda Now,” provide the framework and give practical advice for redefining your vision for procurement and implementing the required changes.

We cannot predict which chapters will resonate most with your executive team and your procurement organization; everyone’s situation is, of course, unique. But we do believe that the chapters’ collective contents add up to a message you cannot afford to ignore.