# Swagging the biggest decisions you make

David Jacoby

Sourcing is getting more strategic every day as buyer and supplier industries consolidate, leaving fewer players on either side to choose from. According to a recent Boston Logistics Group study, supplier rationalization is the top priority of sourcing executives and managers, but it isn't always a choice. On the buy side, mergers and acquisitions have reduced the number of buying organizations and buyer lean management practices have reduced the number of key suppliers they deal with. On the supply side, many suppliers are refocusing on more profitable customers to keep margins up and some are exiting unprofitable businesses or shedding unprofitable customers. The result: fewer buyers are doing business with fewer suppliers.

With fewer suppliers and a larger spend per supplier, sourcing decisions today are becoming more important and more strategic than ever before. Unit savings from economies of scale often need to be balanced against upfront investment costs and downstream switching costs. Choosing one supplier means rejecting another with whom you may have an established relationship and achieving the full benefits of partnering with a supplier may mean committing a lot of volume for a long period.

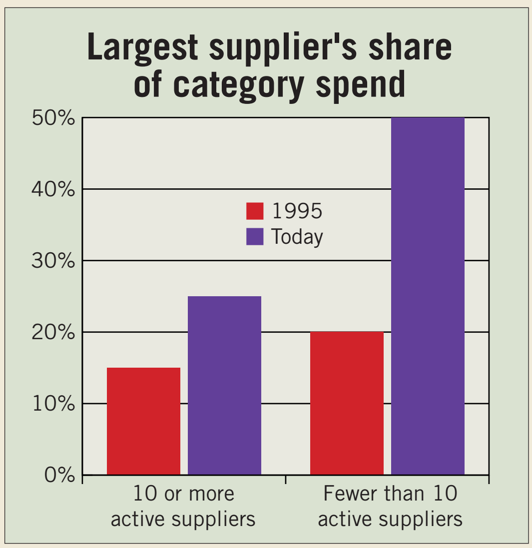
This numbers game makes for bigger, albeit less frequent, sourcing decisions. If you have a few likely suppliers, and all the possible combinations are considered, three major decisions must be made:

**1.** Use one or multiple suppliers
**2.** Commit no volume, some volume, or all volume
**3.** Sign a short-term agreement or a long-term agreement.

Most purchasing departments make these critical, high-value decisions by gut feel. There are few good methods for making complex decisions involving risk, and those that exist are not widely known. Organizations are culturally disinclined to make big new commitments; most would rather make incremental commitments to suppliers by awarding more business only after the supplier demonstrates an ability to successfully execute the current base load. And since these decisions are political in nature, politics sometimes overrides logic.

By single sourcing, a purchasing organization can usually achieve price leverage by taking advantage of the supplier's economies of scale, and, at the same time, reducing administrative and product or service design cost by spreading overhead across more volume and integrating supply chains. However, buying from one supplier incurs a risk of supply interruption or delay (for example, from a strike or fire, or a quality problem). And once the switching costs are incurred, relying on a sole supplier can create a captive situation, raising the possibility of justified or unjustified price increases.

By committing volume, purchasing can gain price leverage and enhanced trust in the relationship. However, the committed volume may not materialize, and the volume agreement limits flexibility to change suppliers as supply and demand market conditions evolve. The question: what level of price benefit offsets the risk when and if the demand does not materialize as projected?




**Doing more with less: Buyers are putting more of their spend through their biggest suppliers in an effort to streamline and increase volume discounts.**

Signing a multiyear agreement (the term varies, but is often standard within a company) enables suppliers to secure lower material costs and reduce overhead, but increases risk of losing flexibility. Over time, demand could fluctuate. Global cost differentials or exchange rates could make other sources more attractive. And country or political risk may result in currency inconvertibility or any number of other undesirable situations.

Difficult decisions such as how many suppliers to have, how much volume to commit to each, and how long contracts should be, have right and wrong answers. Decision support tools can provide the right answers by helping to model probability, scenarios and real options. Algorithm-based tools can facilitate a better outcome than intuition when it comes to risk tradeoffs, and provide a strong basis for win-win negotiations with core suppliers. Although it takes more effort to develop and use them than to fall back on a more intuitive approach, proper analysis results in more defensible decisions and, more important, reduces the risk of strategic partnering mistakes.

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