Driving Outstanding ROIC and EPS through World Class Supply Management

A White Paper for Executives by Robert A. Rudzki

For most companies, more than 50% of their cost structure stems from procurement and supply chain costs. But too many senior executives do not appreciate the impressive role that more astute, proactive management in those areas can play in meeting financial goals, including improving return on invested capital (ROIC). Leading expert and author Robert A. Rudzki, a former Fortune 500 executive who is now CEO of Greybeard Advisors, discusses how managers can identify deficiencies in their procurement practices and then details steps companies can take to reduce costs and improve overall performance on a sustainable basis. Rudzki says it is often possible to achieve double-digit cost reductions and ROIC above 20% – but it requires a senior management-led, enterprise-wide effort, supported by a carefully-designed transformation roadmap. He explains how.

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Sections

Too many companies have already taken a fatal bullet, but don't yet realize they are dying. In the last 10 years, a meaningful number of Fortune 500 companies have gone out of business or otherwise fallen from the top 500 rankings. That's just one indicator that something is amiss. But consider this fact: in that same 10 year period, over 600,000 American businesses of all sizes filed for bankruptcy. All of these companies were "walking wounded" at some point, but failed to take effective action to staunch the bleeding of poor performance before it was too late.

In this white paper I'll show you how to determine if your firm may already be among the "walking wounded," and share some proven strategies that are more than a Band-Aid approach to regaining corporate financial health.

Concerns of C-Level Executives (CEOs, COOs, CFOs)

When I was a senior executive with two large corporations, I knew what was keeping me and my "C-level" colleagues awake at night. Today, as a consultant and advisor working with other firms and executives, I find that their drivers and concerns are about the same. Senior corporate officers tell me that they need to:

(a) Meet or exceed the earnings expectations of Wall Street and their investors.

(b) Achieve growth in revenues and earnings, and sustain that growth year-over-year.

(c) Reduce the volatility in revenues and earnings and thus reduce surprises and risk.

(d) Improve Return on Invested Capital (ROIC) and thereby reduce the amount of capital needed to fuel the growth of the business.

(e) Create a business model that is difficult for competitors to copy.

One of the best kept secrets in the business world is that advanced procurement and supply management can impact <u>all</u> of these senior management objectives—simultaneously.

Proctor & Gamble and United Technologies are two companies that are performing exceptionally well in their industries, and they are widely regarded as among the very best managed companies in the world. Their stories, as profiled in the book *Straight to the Bottom Line®*, highlight the role that procurement and supply management can have in turbo-charging the performance of companies. P&G and UTC are examples of exceptional corporate performance due, in part, to elevating supply management to a strategic role.

Let's assume that your firm is like most companies, and not performing at the level of a P&G. How would you know if your company is already in trouble, and—more importantly—what could you do to dramatically improve your financial performance regardless of your current level of business performance?

ROIC as an Indicator of Health or Trouble

In classic financial management courses, the professor will tell you that to enhance shareholder value you must achieve returns on invested capital greater than your company's cost of capital. The best-performing companies, and the best stocks over time, tend to be those that have ROIC greater than their corporate cost of capital.

The flip side of the equation is more sobering. When your ROIC is less than your cost of capital, the lifeblood of your firm is draining away—you are among the walking wounded. How fast your firm dies will depend on how much of a shortfall exists between ROIC and cost of capital, and how much you have in financial reserves to fund that shortfall. In the absence of ROIC improving, the firm inevitably disappears.

ROIC is typically defined as earnings of the business, divided by the capital invested in the business.

When you increase profits, that improves ROIC, and it also improves cash flow. When you improve capital utilization, that improves ROIC and cash flow. When you improve both profits and capital utilization, you create a powerful compounding effect on both ROIC and cash flow (see Figure on the next page).

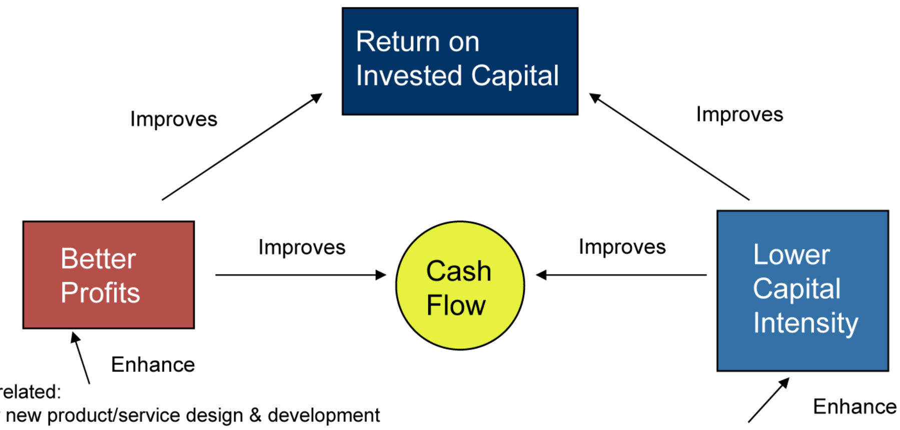
Obviously, then, ROIC is dependent on the profits of a business, in relation to the assets invested in the business. As we'll see shortly, advanced procurement can have an enormous positive impact on all elements of the ROIC equation.

With regard to the top-line of the income statement—the revenue line—success with customers is often heavily influenced by the effectiveness of your supply chain. How well do your suppliers work in tandem with your own organization? Getting the supply side in good shape can help to grow revenues and change the competitive dynamics in your favor. Just imagine the impact on your business if you could make it to market with new products months—if not years—ahead of your competition, and with a lower cost structure.

With regard to costs, in most companies more than 50% of the cost structure relates to procurement and supply chain costs. In spite of that importance, most senior executives don't know where to start to dramatically reduce those costs and improve their bottom line on a sustainable basis.

ROIC = Earnings divided by capital invested in the business (long term debt plus equity)

Advanced Procurement Can Improve ROIC in Many Ways



REVENUE related:
- Faster new product/service design & development
- Optimum & reliable parts & raw materials suppliers
- Excellent transportation service providers

COST related:
- Reduce freight costs & claims
- Reduce raw materials costs
- Reduce indirect materials/services costs
- Reduce manufacturing variability

WORKING CAPITAL related:
- Improve payment terms with suppliers
- Utilize inventory programs with suppliers

CAPITAL EXPENDITURE related:
- Improve redeployment of used assets ("asset recovery" programs)
- Reduce total costs associated with capital spending

And, with regard to the assets invested in the business, advanced procurement and supply management—working with the supply base—can have a significant impact on working capital levels, and on capital projects, thereby favorably impacting ROIC and cash flow.

There are many strategies to address each of these important drivers of ROIC. We'll take a look at each component strategy, and then show you the magnitude of what is possible. Then, we'll address the specific topic of how you can put it all together into a successful transformation plan that can turbo charge your Return on Invested Capital—and make the difference in your company's future.

Procurement Strategies That Can Impact Total Business Performance

In the last 20 years, world-class procurement departments have adopted new, powerful processes and tools to unlock and create new shareholder value, to accelerate change, and to create powerful supply chains with which their competitors are now trying to catch up. So, what are the key strategies that you need to know in order to add value to your bottom line?

When it comes to improving margins and profits, procurement can have an impact through initiatives that favorably impact revenues and other initiatives that directly target costs of the business. For example, on the revenue enhancement side, more companies are beginning to realize the value of working collaboratively with suppliers on innovation, and on reducing the cycle time from product concept through delivering that new product to the marketplace. With regard to costs, world class companies view all areas of spend as being within the scope of modern procurement practices (i.e., no category of spend is too "strategic" or off limits), and pay particular attention to reducing maverick spend and ensuring compliance with negotiated contracts.

When it comes to improving the capital intensity of the business, procurement can have an impact through initiatives that favorably impact working capital—and initiatives that impact the total investment in capital assets. For example, payments terms offer enormous opportunity to add value and financial flexibility, by negotiating longer "net" terms, plus attractive discount options if you elect to pay early. Similarly, inventory programs offer the opportunity to free up significant working capital, and so-called "asset recovery" initiatives offer a disciplined approach to realizing value from underutilized or idle plant and equipment.

To summarize the framework we have discussed so far, advanced procurement—if given the right role, the right tools and adequate resources—can directly impact all four strategic drivers of ROIC and cash flow.

What is the Potential Impact on My Business?

Let's now take a closer look at the degree of impact that procurement can have in several key areas.

For example, what is possible in revenue support and enhancement? Consider the subject of new product development cycle time. Would reducing the time from product concept to shipping improve your competitive standing and win new sales? If you could reduce that cycle time by 50% and beat competitors to market, while also reducing total sourcing and manufacturing costs, would that be a plus for your business? For most companies, that would have a huge positive impact. Supply management, working closely with key suppliers, can help make this happen.

With regard to costs, the conventional wisdom is that procurement should focus principally on the "big ticket" areas of spend, such as raw materials and energy. And, you certainly should devote attention to raw materials and energy—not just to reduce costs, but also to reduce volatility through better risk management.

But, if you focus only on the big ticket spend categories, you'll be missing out on the enormous opportunities presented by all other, indirect areas of spend. It is often possible to achieve double-digit reductions in costs for those indirect spend categories (see next Figure).

What is Possible in Cost Reduction?

Category	Benchmarks
Raw Materials	2 to 5 % & Better Risk Mgmt.
Packaging	10 to 20 %
Indirect Materials and Services	10 to 20 %
Information Technology	15 to 30 %
Professional Services	8 to 15 %
Logistics/Transportation	7 to 15 %
Media, Marketing, Promotional Items	10 to 20 %
Other Indirects	5 to 15 %
Capital Projects	7 to 15 %

Source: Greybeard Advisors benchmarks and experience

The bottom line is this: focus on both direct and indirect spend. Doing so can have a powerful effect on corporate performance.

A few years ago, I was interviewing the president of a major business regarding his impressions of the company's procurement activities. He offered some very specific advice: "Bob," he said, "we need to spend more time and effort on raw materials costs." I asked him why he said that. The answer was simple: "Because it's the biggest part of my cost structure."

I took out a pen and paper, and proceeded to sketch out the illustration you see on the chart below. He suggested that he would be happy with a 2–3% reduction in raw materials costs. I said, let's shoot for at least 5%, which in my experience is achievable.

I then told him that for the so-called indirect spends (those things which don't become part of the physical product), it is often possible to achieve 15–20% cost reduction. I completed the math on the page, and his reaction was straightforward: "Let's get started!"

What's Possible in Cost Reduction - The Math May Surprise You

Hypothetical manufacturer:	
Raw Materials purchases: assume 5 % cost reduction:	**$ 1.0 billion** $ 50 million step change in cost structure
Indirect Materials & Services: assume 15 % cost reduction:	**$ 0.5 billion** $ 75 million step change in cost structure

With regard to working capital initiatives, modern procurement departments are including payment terms in their Requests for Proposals (RFPs) and are often pleasantly surprised by the responses. This can have a very meaningful impact on your business. For example, for each $100 million of purchases, moving from Net 30 days to 45-1%-15 offers the option of:

(a) taking the payment discount and improving earnings by about $1.0 million/year (minus the interest earnings on the cash used to pay early), or

(b) the ability to grow Accounts Payable and Cash by about $4.0 million, by paying in 45 days.

Similarly, including inventory terms in the RFP can offer suppliers the opportunity to show their creativity as well. Inventory programs with suppliers can free up tens of millions of dollars in capital for other purposes.

For capital projects, there is a direct correlation between the total costs associated with that project and the moment that procurement is involved. The message here is very simple: involve procurement *and suppliers* at an early stage to optimize the total costs of any capital project. I've seen it happen too many times. Well-intentioned engineers and plant operators go running down the path of conceptualizing the project, and designing the equipment, before seeking any input from their professional procurement colleagues.

Getting procurement and suppliers involved early in the process, even at the concept stage, makes it more likely that the best ideas are considered before it is too late, and that the commercial foundation for success is established before too many "technical details" are locked in.

An Illustration of What Is Possible

I've been describing some of the impacts that advanced procurement and supply management can have in particular areas relating to improving profits, and improving the capital intensity of your business. Let's pull it all together with an illustration of an income statement and a balance sheet.

In the figure below, you'll see a simplified income statement for our hypothetical manufacturing company.

Turbo Charge Your ROIC – Income Statement

	Pre-Transformation
Net Sale	25.00 Billion
Purchased Goods/Svc	15.00
Other Cost of Goods Sold	5.50
Gross Profits	4.50
SG&A Expenses	3.00
Depreciation & Amortization	0.50
Income before Taxes	1.00
Provision for Inc. Taxes	0.20
Net Income	$ 0.80
EPS	$2.00 per share

$800 million net income—not bad, you might say. Well, whether it is good or bad requires some additional information.

In the next Figure you'll see a simplified balance sheet for the same company—very consistent with the size and profitability shown on the prior chart.

The ROIC for this company—*pre*-transformation—is calculated by taking the net income and dividing it by the total sum of long term debt and stockholders equity. In this example, the company has an ROIC of 7.8%.

Turbo Charge Your ROIC – Balance Sheet

	Pre-Transformation
Cash & Equivalents	$ 2.00 Billion
Accounts Receivable	4.00
Inventories	3.00
Property, Plant & Equip.	4.00
Other Assets	7.00
Total Assets	20.00
Accounts Payable	1.25
Other Current Liabilities	5.50
Long Term Debt	4.00
Other Long Term Liabilities	3.00
Total Liabilities	13.75
Total Equity	6.25
Total Liab. & Equity	$ 20.00 Billion

ROIC =
$800 / (4,000 + 6,250) =
7.8% Pre-Transformation

We need one more piece of information to complete our pre-transformation assessment—this company's weighted average cost of capital is about 10%.

This company's ROIC is less than its cost of capital. It is among the walking wounded. Whether that condition proves fatal will depend on the actions that its management takes to significantly improve ROIC.

Now comes the fun part. The changes which are possible—based on what I've described so far, are identified in blue in the next Figure. Revenues are shown to increase 3%, purchased goods and services costs (as a % of revenues) are reduced from 60% to 55%, and SG&A

expenses as a % of revenues are reduced by 1%. Those three improvements—which, by the way, are very achievable based on Greybeard Advisors' benchmarks—have a large cumulative impact on net income and EPS.

Turbo Charge Your ROIC – Income Statement

	Pre-Transformation	Post-Transformation
Net Sales	$ 25.00 Billion	$ 25.75 Billion
Purchased Goods/Svc	15.00	14.16
Other Cost of Goods Sold	5.50	5.67
Gross Profit	4.50	5.92
SG&A Expenses	3.00	2.83
Depreciation & Amortization	0.50	0.50
Income before Taxes	1.00	2.59
Provision for Inc. Taxes	0.20	0.60
Net Income	**$ 0.8 Billion**	**$ 1.99 Billion**
EPS	***$2.00 per share***	***$4.98 per share***

The balance sheet changes are shown in the next Figure. The revenue growth causes accounts receivable to grow slightly. Inventory levels are reduced slightly because of the lower level of purchased goods costs plus a modest 2% reduction from inventory consignment programs. Accounts payable grow because the company has renegotiated payment terms from net 30 days to net 45 days. And, the reduction in capital intensity due to the improvements in A/P and Inventories (less the growth in A/R), allows for a pay-down of Long-Term Debt.

Turbo Charge Your ROIC – Balance Sheet

	Pre-Transformation	Post-Transformation
Cash & Equivalents	$ 2.00 Billion	$ 2.00 Billion
Accounts Receivable	4.00	4.12
Inventories	3.00	2.77
Property, Plant & Equip	4.00	4.00
Other Assets	7.00	7.00
Total Assets	20.00	19.89
Accounts Payable	1.25	1.88
Other Current Liabilities	5.50	5.50
Long Term Debt	4.00	4.00
Other Long Term Liabilities	3.00	3.27
Total Liabilities	13.75	13.64
Total Equity	6.25	6.25
Total Liab. & Equity	$ 20.00 Billion	$ 19.89 Billion

ROIC: From 7.8% to 20.9%

The compound effect of better profits and better capital intensity has an enormous impact on ROIC—going from 7.8% pre-transformation, to over 20% post-transformation.

That's real change. And, it's not fantasy. Each of the changes I mentioned is very doable.

What's Needed for Success?

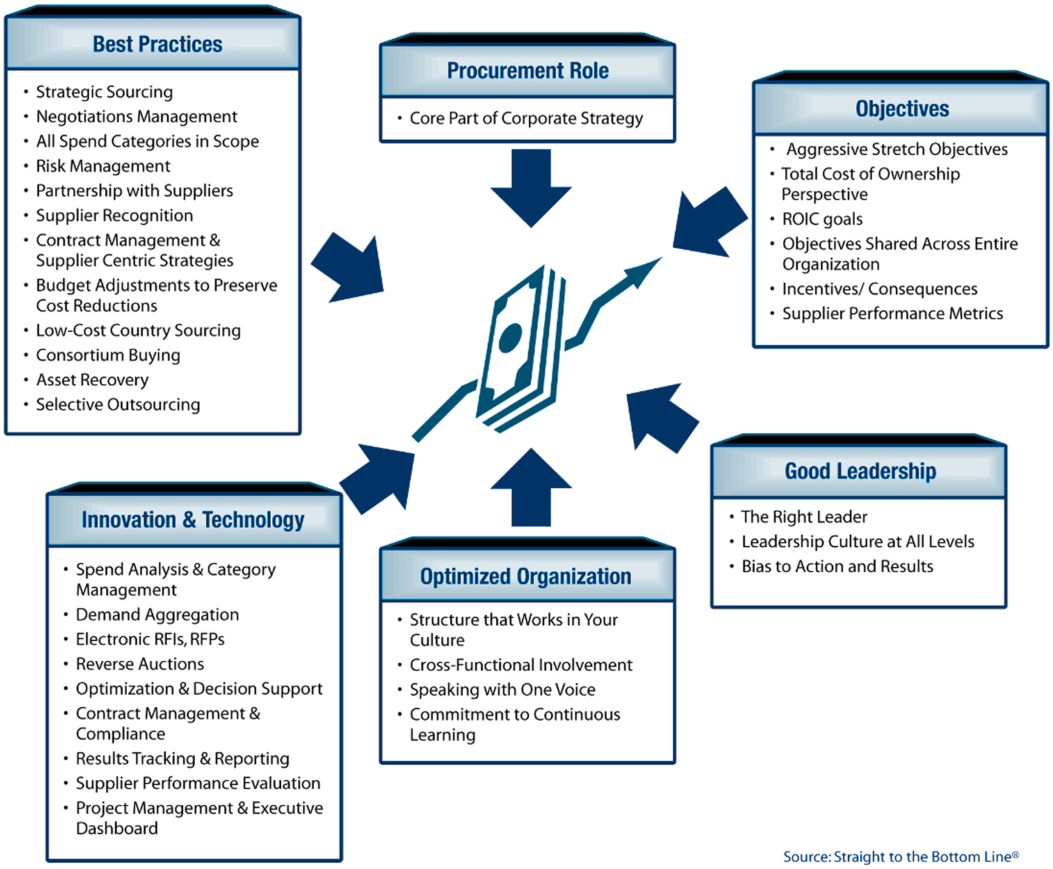
You might ask, why aren't lots of companies performing at 20+ % ROIC? There are two reasons. One, there may be other adverse trends in their business that are partially or completely offsetting the good impacts from advanced procurement. For example, weakening product selling prices, or skyrocketing labor and health care costs. But setting those factors aside for the moment, the main reason you don't see many companies with 20+ % ROIC is that *these improvements don't just happen by themselves.* It takes tremendous leadership, a well thought-out transformation plan, the right best practices in the right sequence, effective and enabling technology, and a few other key ingredients. That's one of the reasons I collaborated with my co-authors on the book *Straight to the Bottom Line*® (go to www.GreybeardAdvisors.com for more info about the book).

Straight to the Bottom Line®:

Driving Outstanding ROIC and EPS through World Class Supply Management

When the authors first met to frame out the book, we looked for common success factors in the eight procurement transformations we have led in our careers and other success stories we are familiar with. One of the ways we summarized our framework for success is shown in the next Figure—which highlights six key areas of attention.

Taking it Straight to the Bottom Line ®– Some of the Key Elements



Source: Straight to the Bottom Line®

The first critical element of success or potential failure relates to the role which procurement has in your organization. Companies who make procurement and supply management a core part of their corporate strategy are more likely to have great results and success.

The next area of attention relates to objectives. It's important to have stretch objectives that are based on a total cost of ownership perspective, ROIC goals, and it's also critical that these objectives are shared across the entire organization.

To say it another way, if procurement's objectives are **not** shared by operations and other key functions, the chances of success are diminished.

Just a few topics from the category of optimized organization: it's important to have a structure that works well in your organization's culture. That can mean centralized, or center-led hybrid. It might even mean decentralized if you have a very decentralized corporate structure, though the internal politics of a decentralized corporate structure can be successfully addressed if you design a center-led approach properly.

Cross-functional involvement is also critical for success, as is having the entire organization speak with one voice in any contact with suppliers.

Good leadership involves having the right senior person. It also involves encouraging and developing a leadership culture at all levels of the organization. Furthermore, it involves creating a bias toward action and results.

A key enabler is innovation and technology. The sub-functions shown here can provide significant value to your activities. And, better yet, solutions available today are proven and well-integrated to ensure that the savings negotiated upfront by procurement actually make it to the bottom line. One of the historical challenges facing procurement managers has been that many of the technology tools that supported procurement were separate, standalone applications or only available via consultants, making it difficult (and expensive) to use them broadly to have the type of impact we demonstrated in the example above. That has changed dramatically and you need to see what is possible today.

Finally, best practices are critical to a successful transformation. Learning, and embedding, these 12 best practices are the foundation of generating sustainable results.

Compliance, Results and the Role of the Financial Office

Back in 1994, when I was offered the opportunity to step outside my financial career track and run the global procurement and transportation operation of Bethlehem Steel, I had a memorable meeting with my new boss, the President and COO of the company. He offered me an observation which guided my early plans. "Purchasing keeps telling me they're saving this company millions, but I can't find it on our income statement."

There are numerous reasons why savings reported by the procurement department fails to hit the bottom line. One of the principal culprits is maverick spend.

In the final Figure, you'll see a table I refer to as the "Strategic Sourcing – Compliance Multiplier." The matrix shows different levels of negotiated cost reduction for a new contract (5%, 10%, 15%, or more), and different levels of compliance with that contract (from 25% up to 95%). The table shows the amount of benefit that actually makes it to the bottom line based on each combination of negotiated cost reduction and actual compliance. Just to make the illustration easy to follow, we are assuming a $10 million dollar amount of spend that could be directed to that new contract.

For example, a fairly typical result might be to negotiate a 5 to 10% cost reduction with your supply base. That sounds pretty good, until you realize that in many companies the initial compliance with that new contract might only be 25 to 50%. So, what you are looking at are true, bottom-line results in the top-left boxed area.

For modern procurement to really add value, it needs to *utilize best practices to identify the best suppliers and negotiate world-class contracts,* and then ensure a high level of compliance.

Strategic Sourcing/Compliance Multiplier

Compliance with new contract

% Cost Reduction	25%	50%	75%	85%	95%
05	$125,000	$250,000	$375,000	$425,000	$475,000
10	$250,000	$500,000	$75[illegible]	$850,000	$950,000
15	$375,000	$750,000	$1,125,000	$1,275,000	$1,425,000
20	$500,000	$1,000,000	$1,500,000	$1,700,000	$1,900,000
25	$625,000	$1,250,000	$1,875,000	$2,125,000	$2,375,000
30	$750,000	$1,500,000	$2,250,000	$2,550,000	$2,850,000

($ to the Bottom Line for each $10 Million of spend)

Best Practices + Good Compliance = $ to the Bottom Line

On the chart you can see the impact of negotiating a 10 to 15% cost reduction, combined with a 85 to 95% level of compliance. And, to really make sure it gets to the bottom line, it's critical to communicate the new contracts and relevant spend to your controllers, and ask them to adjust budgets so that the favorable variances created by your sourcing successes are not automatically spent on other things.

In this chart, we are looking at the prospect of a significantly-higher number hitting the bottom line. And getting good results to make it *Straight to the Bottom Line*™ is what it's all about.

So there you have it: the basic framework to successfully transform procurement into a driver of shareholder value for your company. Not easy to do, but it can be done. And, the benefits are well worth the effort. The immediate benefit is that you can avoid being among the "walking wounded." The longer term benefit is that you can turbo-charge your organization's financial performance, and help to contribute to its success well into the future.

For additional information about assessing your organization's supply chain practices and creating an effective transformation roadmap, go to www.GreybeardAdvisors.com.

About the Author

Robert A. Rudzki is President of Greybeard Advisors LLC (www.GreybeardAdvisors.com), a leading provider of advisory services for supply chain management, with an emphasis on strategic sourcing, procurement and logistics. Mr. Rudzki also is an Advisory Board member of several companies.

Mr. Rudzki has more than 25 years of leadership experience across several industries. He has personally led several business transformation efforts that resulted in significant enhancements in corporate performance.

Prior to founding Greybeard Advisors in 2004, Mr. Rudzki served as Senior Vice President, Materials Management and Chief Procurement Officer for Bayer Corp. At Bayer, he led a nationally recognized transformation that generated significant improvements in costs and working capital, and was a finalist for Purchasing Magazine's "Medal of Excellence." Prior to Bayer, he was an executive at Bethlehem Steel Corp., where he oversaw Bethlehem's global procurement and transportation activities, which were recognized as "top quartile" in a global benchmarking study conducted by A.T. Kearney, and recognized by Purchasing Magazine as a "Best Place to Work." In the course of his career, he has held various executive management positions, which included finance, accounting, procurement and logistics, business development and P & L responsibility.

A frequent speaker at professional conferences and seminars, he is co-author of the supply management best-selling book *Straight to the Bottom Line®* and author of the leadership book *Beat the Odds: Avoid Corporate Death and Build a Resilient Enterprise.*

Mr. Rudzki holds an M.B.A. (Finance) from The Wharton School. He graduated Phi Beta Kappa, *summa cum laude,* from Lehigh University with a B.S. in industrial engineering and a minor in chemical engineering. He also attended executive programs at Carnegie-Mellon's Tepper Business School and Duke University's Fuqua School of Business.

Start Your Company on the Road to a Better Bottom Line

It's a fact that every executive knows: Every dollar in cost savings goes straight to the bottom line. And that fact is especially important during challenging economic times.

But how can your organization generate cost savings without compromising quality and service? And just as importantly, how can you sustain your improvements over the long haul?

Discover Greybeard Advisors, a leading provider of advisory services for procurement and supply chain management. We've helped companies like yours:

- Drive fast improvement in EBIT
- Adopt best practices that build a foundation for future cost savings
- Embed new skills so your organization can sustain and build improvements on its own.

DRIVE IMPROVEMENT TO YOUR BOTTOM LINE, SHORT- AND LONG-TERM

Our "fast plan" can generate quick improvement in EBIT. But then we move beyond — helping you sustain these quick wins by introducing business processes that enable your organization to make continuous improvement on its own.

ENJOY THE ADVICE OF EXPERIENCED ADVISORS, NOT NEWLY MINTED MBAS

Greybeard isn't like conventional consultants you may have worked with. Our advisors have deep, real-world business experience. They're expert practitioners who've been "where you are" — and confronted the full range of supply chain and procurement challenges head-on. Plus, Greybeard has worked across a broad spectrum of industries and market sectors.

SUPPLY CHAIN MANAGEMENT: WE WROTE THE BOOK ON IT

We embed world-class business and supply chain processes that help your company think beyond the tactical buy. Many of these practices are drawn from our CEO Robert Rudzki's book: *Straight to the Bottom Line,®* a best seller in the supply chain management and procurement field.

WE CUSTOMIZE OUR APPROACH TO YOUR UNIQUE NEEDS

We’re flexible. We tailor our plans to be sensitive to your culture and to the everyday realities of your workplace. From guiding strategic transformation, to mentoring and developing your staff, to advice on practical matters such as supplier negotiation, Greybeard is ready to roll up our sleeves and start working on your challenges.

CONTACT US TODAY

Contact us today to learn more or to request a proposal. And start your company on the road to a better bottom line.

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