Strategic Sourcing in Retail: How to Survive and Succeed

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Abstract. In the highly competitive retail industry, where margins are driven by consumer spending, retailers are increasingly pressured to control and reduce operating expenses. In the last three years, the Longs’ sourcing team has touched virtually every indirect spend category, from basics like store supplies to high dollar complex construction categories, resulting in profit improvement for Longs and their shareholders.

Sourcing Evolution at Longs. The transformation at Longs from traditional sourcing to electronic sourcing occurred in relatively rapid fashion. No different from other retailers, Longs faced fierce competition from other chain drug, grocery, and mass merchandisers. Procurement goals were simple - to reduce operating expenses and increase the profit of goods sold to improve shareholder value as soon as possible.

The first year was all about implementing a strategic sourcing program at Longs, which included conducting a major analysis and category prioritization of enterprise spend, establishing an electronic negotiations technology platform, and training category teams on electronic sourcing (“e-sourcing”) strategies and execution. Sounds easy enough, except for the fact that most people are generally skeptical about how e-sourcing can not only save them money, but compress negotiation time as well. As a result, there is quite a bit of internal selling that takes place in the first year, which can sometimes be challenging as nobody wants to be the guinea pig in this novel program.

First year successes with cost reduction primarily in indirect spend categories led to the widespread realization that strategic sourcing can be leveraged across all types of categories, from the simple to more complex projects. In the second year, the sourcing department negotiated many categories slated for the construction of the new Longs Distribution Center in Patterson, California; and the decommissioning and sale of assets at the old distribution center in Lathrop. The efforts resulted chiefly in cost avoidance in many categories, such as material handling equipment, racks and shelving, warehouse vehicles, office furniture and equipment, security equipment and services, etc. Acceptance of the process saw increased strategic sourcing, including sourcing of private label merchandise that yielded reduced costs, increased promotional funding, and greater supplier consolidation. This in turn helped to create additional efficiencies in supplier and contract management.
Now that the program is established and well-accepted, the challenge is to continue to find cost reduction opportunities, especially when the low-hanging fruit is picked through. Longs continues to improve upon forecasting through favorable and predictable contract terms that call for price adjustment mechanisms based on published indices.

**Factors to Successful Negotiations.** Generally speaking, a proven process facilitates organization and resource setting. The Longs’ sourcing department is small and nimble, and leverages department resources to get the job done. A category team has to be ready with basic information, such as category total spend, product description/specifications, quantities, unit cost, business owner requirements (e.g. “must haves” and “nice to haves”), and suppliers, so that the sourcing manager can apply a return on investment (“ROI”) to the effort (e.g. determine savings potential against resource outlay) to prioritize the project in the queue. Factors such as compelling spend, clear specifications or scope of work, competitive supply market, and credible switching threat all contribute to the ultimate decision to proceed with a sourcing effort.

In most cases, the challenge is getting the category data and information initially due to the disparate systems inherent with Longs. Supplier research adds to the incumbent list and is often conducted by the sourcing department to improve competition. The most important factor in managing a sourcing team is not necessarily the category knowledge that is often expected of the sourcing manager, but the communication and managing of expectations of both internal and external stakeholders (e.g. suppliers). A framework for the sourcing process may be defined, but there are still many moving parts, and everyone plays a role in its success.

**“We are Not all about Auctions.”** There may be a perception that all we do is auctions. Granted that our job revolves being resident experts in the world of electronic negotiations, the Longs sourcing team has been recognized as key players in the negotiation skills used above and beyond auctions. Negotiating non-monetary components (such as lead time and warranties) can be done electronically, however we do not lose sight of the reality that a purchase agreement includes terms beyond what can be negotiated online. We sometimes serve as deal makers/brokers between the category team and suppliers, negotiating business expectations, performance metrics, and other commercial terms that are mutually beneficial to both parties. Category owners recognize that a great price can be quickly burdened by unfavorable commercial terms, and sometimes it is just easier to have the Longs sourcing team be the “bad guy” while hammering away at the finer points. Ultimately the category owners have to live by the terms, and having a third party wade through the “must haves” and “nice to haves” to maximize the value of the agreement while also incorporating internal process changes is always beneficial.

**Contractual Compliance and Performance Feedback.** Undoubtedly, the toughest part of the sourcing process is to get the purchase agreement negotiated and fully executed. Many times the category team is so giddy from the success of the sourcing initiative, that they lose sight of the fact that the deal is not consummated until both parties sign on the bottom line. An unexecuted agreement is worthless, and the painstaking effort to negotiate favorable terms can vaporize what leverage you had to begin with. To ensure price protection and/or predictable price adjustments for forecasting purposes, as well as sustainable product quality and service through the life of the agreement, the team is required to stay focused and unified
in getting the deal fully executed as quickly as possible before the honeymoon is over. As they say, marriages are easy compared to the divorce proceedings. It is in the best interest of all parties to hash out the “what happens if things go wrong” up front, rather than suffer the consequences of bad performance midway through a contract term.

Every company has its standard terms and conditions, and it is imperative for the sourcing manager to be familiar with them since they impact sourcing and negotiation strategies. For example, don’t negotiate “1% 10 days, net 30 days” when the company can not turn an invoice around in 10 days. Talk to Accounts Payable to find out what is realistic; perhaps it should be “1% 20 days, net 30 days.” Don’t lose sight of the fact that a contract is an agreement between two parties, and should be honored in good and bad times. The buyer should not force a supplier to honor a lower price when the contract clearly states that they are entitled to adjust based on a negotiated predefined market index.

Like any relationship, business or personal, communication is highly necessary. It is not unreasonable to provide real-time feedback, both positive and constructive, to suppliers. Communication should be bi-lateral, and the suppliers should have an opportunity to express their concerns if the buyer is incurring unexpected costs. Key performance indicators (“KPI”) should be defined in the agreement, and the process by which they are measured and monitored should be consistent. If a performance improvement plan is required, it should be developed jointly with defined objectives and realistic goals in mind.

**Case Study - Waste Hauling.** Waste hauling was put through the strategic sourcing process in August 2005; however it continues to demand vigilant oversight. Originally, cost control of waste hauling expenses was needed in an effort to fully right-size trash receptacles. Further, improved waste hauling service was needed to provide greater alignment between management and the waste hauling service provider. Longs also recognized that increased environmental awareness was necessary to succeed in a highly visible, regulated category such as this. The original spend has increased significantly due to both increased store operations as well as increased municipal taxes. The potential savings was less than 10%; however the opportunity to gain additional insight into this category was a deciding factor to switch service providers.

This service category continues to be a struggle, as it is for most retail operators with numerous locations, due in part to the lack of on-sight control over the trash receptacles, as well as the inability to interact directly with city haulers on a day-to-day basis. Reliance on a waste hauling service provider makes strategic sourcing a necessity to gain full oversight over this category.

**Case Study - Private Label Foods.** Private label foods have been strategically sourced in the sourcing department for the past three years. This category is particularly conducive to strategic sourcing due to the uniformity of product specifications, and the seasonality of the product life-cycle. Longs has explored replacing branded products with private label in order to improve gross profit, and to further define/define the Longs brand. In the past, we have sourced canned fruits and vegetables, canned fish, coffee, tea, pasta, soup, broth and specialty jar products with great success. Participants bid on product pricing, promotional funding, and price guarantees. The sourcing department also reviews copies of Private Label Buyer, which is useful for supplier searches and category reviews.
**Case Study - Index-Based Pricing.** Many of the categories that are sourced by Longs’ sourcing department consist of raw materials that fluctuate in price. Paper bags, corrugated packaging, shrink wrap recycling, corrugated recycling, and plastic bags are all subject to swings in prices due to raw material surplus/shortages, and do well when tied to a widely-publicized commodity index. Longs has entered into numerous contractual arrangements that contain price adjustment mechanisms. These serve to protect both the continuity of supply, as well as necessary profit margins for conducting business. Indexes can easily be found in Pulp and Paper Week, as well as Plastics News, for each of the categories mentioned above.

**Where do we go from here?** Categories sourced in the initial years are up for review, and we will focus on further cost reduction strategies (i.e. lessons learned have given us ideas about improvements in future sourcing). In addition, we will explore opportunities to increase our self distribution.