



INSIGHTS ON AUTOMOTIVE SUPPLIER EXCELLENCE

SOURCING IN THE AUTOMOTIVE INDUSTRY:
HOW CAN SUPPLIERS CREATE MORE VALUE?

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Automotive suppliers need to perform in an increasingly challenging business environment. The competitive pressure, for example on costs and from customers' quality expectations, is high. At the same time, the supply chain is growing in complexity due to its broader and often multiregional production footprint as well as its rising share of automotive value creation. As the cost of purchased goods and services typically represents up to 70 percent of cost of goods sold, reducing the purchasing cost of products and materials is a key driver of a supplier's profitability. Therefore, it should be at the top of the C-Suite's agenda.

The automotive industry has always been at the forefront of developing sourcing approaches that are both robust and competitive. In terms of improvements in sourcing, the "low-hanging fruit" have already been harvested at many firms. The question that automotive suppliers now face is "What additional, innovative and sustainable approaches can we take to defend or even improve our competitiveness?"

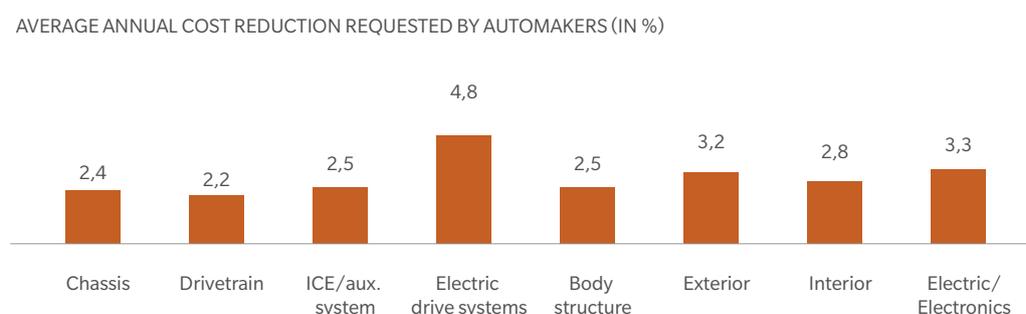
To realize sustainable performance enhancements, top managers need to think beyond the purchasing function. They need to embed procurement holistically across the whole company and, further still, use the entire supply system for both innovation and performance improvement.

CHALLENGES FOR AUTOMOTIVE SUPPLIERS

Automotive suppliers face a number of challenges that affect their supply chain and overall sourcing capabilities.

At the customer end of the chain, suppliers are confronted with uncertainty and the need to be flexible, driven by fluctuating demand, an increasingly variable portfolio, and complex as well as shorter product cycles. At the other end of the chain, they need to manage their own suppliers, drive innovations on functionality and cost improvements and meet with high quality and commonality requirements. On average, an automotive supplier needs to achieve an annual price performance improvement between 2 and 3 percent just to balance the required price-cutting and cost-cutting initiatives for new products from automakers (see Exhibit 1). In high innovation areas, annual price-reduction requests can reach 5 percent.

Exhibit 1: The cost reductions that automotive suppliers need to realize for each category of parts

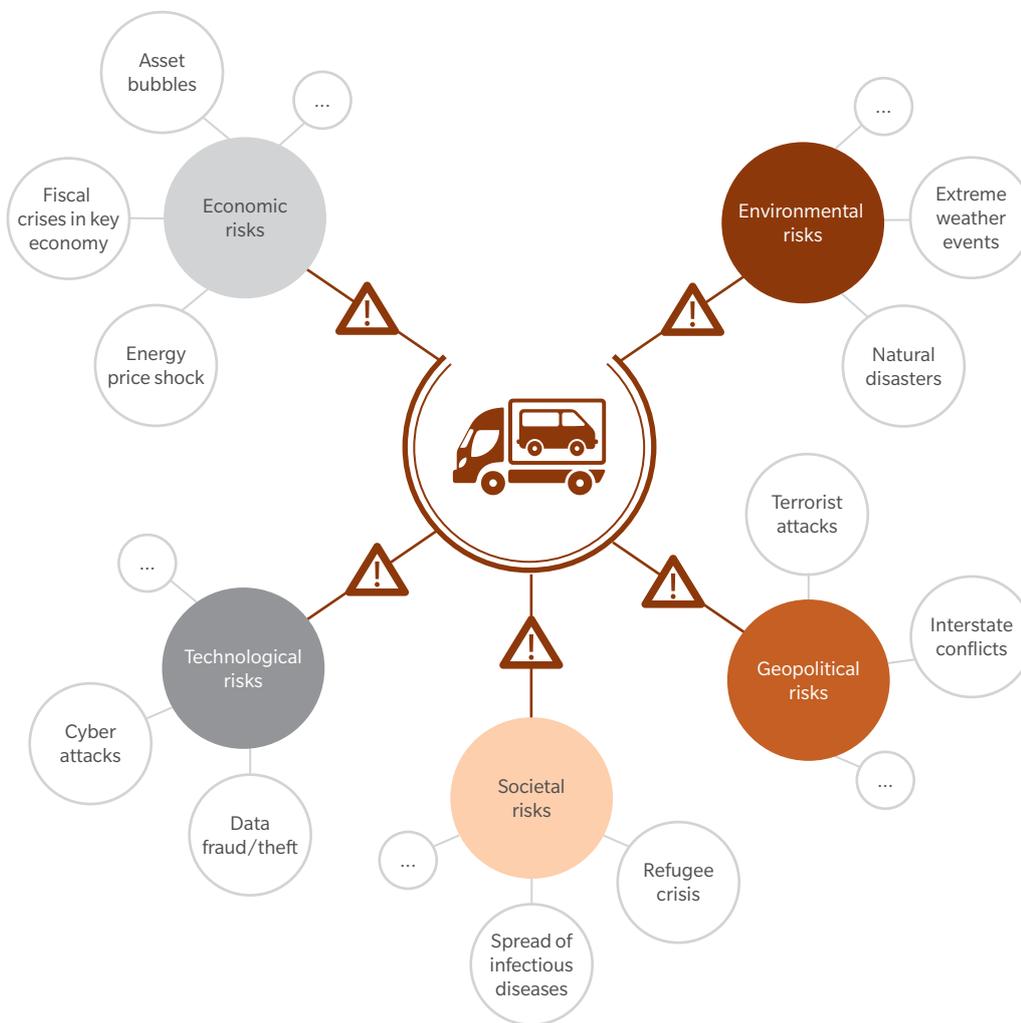


Source: Oliver Wyman research

Supply chains are getting more complex as both automakers and suppliers globalize their production footprints. Value creation continues to migrate towards emerging markets, especially Asia or Mexico. In addition, suppliers are being integrated into automakers' production processes, creating global, cross-linked supply chain networks. Such increased supply chain complexity exposes automotive suppliers to significant risks, including low quality, disrupted production, weak or failing controls, breakdown in logistics, and, in the worst case, financial default (see Exhibit 2).

To address these challenges and remain competitive, automotive suppliers need to adopt a holistic approach to managing costs, quality, and risks. They should also look for methods to establish additional growth from the company's value chain.

Exhibit 2: A wide variety of global risks can have a significant negative impact on automotive suppliers



Source: Oliver Wyman

Such methods could include:

- **Achieving cost excellence** – this requires the continuous realization of savings in material and indirect costs. To do this, the procurement function needs to be involved in the full value chain. The savings achieved, and their impact on profitability must be monitored and reconciled.
- **Managing quality and risks** – this calls for more transparency of supply chain risks, building and managing supply chain resilience, translating quality requirements into supply strategies, and taking corporate risks into account in those strategies.
- **Activating growth drivers** – this requires CEOs to manage innovation and build unique capabilities. This cannot be achieved solely in-house, so strategic suppliers need to be leveraged as much as possible to bring in innovation and help the company create areas of differentiation.

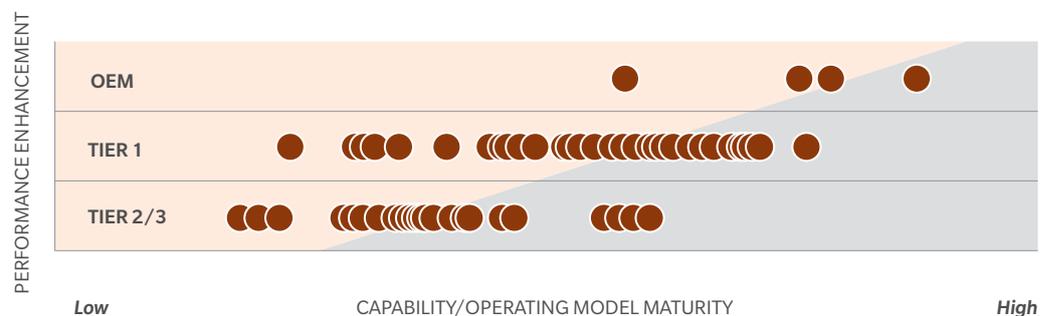
THE DILEMMA

How can suppliers improve purchasing performance in such a difficult environment?

A common approach has been to impose performance targets on chief purchasing officers (CPOs) to achieve cost excellence, manage quality and risks, and introduce innovation to fuel future company growth. And the CPOs deliver: Automotive suppliers continue to improve their operating purchasing model and develop one of the most advanced methods of sourcing in the industry.

Despite this success, automotive suppliers often lag behind automakers in their purchasing performance. Our experience suggests that relative performance is strongly driven by the maturity of the operating purchasing model, by which we mean the purchasing strategy, organization, processes, people, and tools deployed. Companies with higher maturity generally have better control of their spending and realize higher savings per unit of spend. Our benchmarks of the purchasing maturity across automotive industries show that OEMs still set the pace for best practice in sourcing and often outperform their suppliers (see Exhibit 3). Nevertheless, we can observe a huge spread of maturity within each tier.

Exhibit 3: The correlation of performance and operating model maturity along n-tier supply chain positioning



Source: Survey participants, Oliver Wyman

If we look at the sourcing maturity of suppliers, we can see major shortfalls compared to OEMs. Examples include:

- Best-cost country (BCC) sourcing.
- The application of sourcing tools, for example quantitative modeling, regression analyses, or role play to prepare for negotiations.
- Systematic management of supplier panels, which should include the supplier development process, integration of new suppliers, and innovation or improvements in idea management.

These maturity gaps are indicative of the dilemma automotive suppliers are facing. They are unable to systematically outperform automakers and thus leak the value they realize with their own suppliers directly to the automaker. Unfortunately, leaving the CPO to work alone, and focusing only on improving these shortfalls within the purchasing department, will not sustain higher performance in the long term. For example, launching new products or tapping into new markets affects the sourcing strategy. Costs and supply chain risks are driven by R&D decisions made during the early stages of the product life cycle. Supply chain issues arising during production or the aftersales stage limit the potential supplier pool.

Consequently, realizing the maximum benefit from improvements in material costs and related risks requires the C-Suites to start thinking beyond the purchasing function – and even beyond the company itself.

HOLISTIC VALUE SOURCING: BRINGING ABOUT A STEP CHANGE

To realize sustainable performance enhancement in costs, quality, risks, and growth, automotive suppliers must do more than just improve their transaction-oriented purchasing model. Rather, effective management of the procurement function should be the cornerstone of a holistic transformation process that is geared to embedding value sourcing across the company and throughout the supply ecosystem.

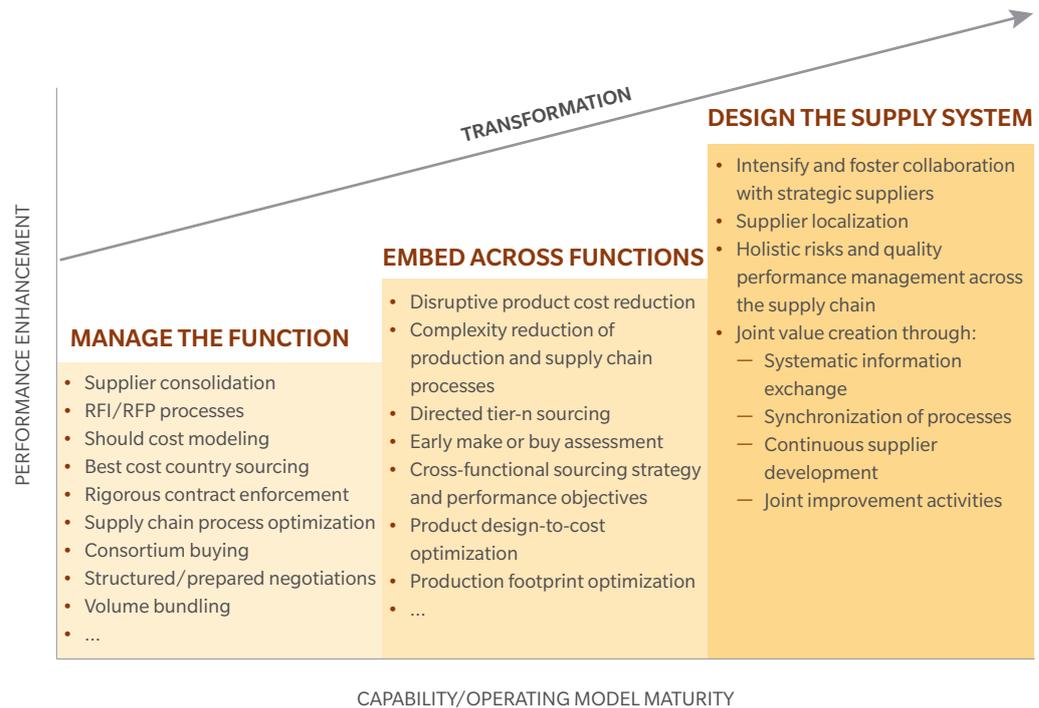
A number of typical improvement levers emerge at each step of such a transformation process, including those outlined in Exhibit 4.

MANAGE THE PROCUREMENT FUNCTION

Getting the basics right means realizing excellence in each sourcing category and establishing synergies across purchasing commodities. Traditional optimization levers include:

- Supplier consolidation and volume bundling (also leading to complexity reduction).
- Systematic and regular execution of global request for proposal (RFP) processes, including a broad search for alternative suppliers, realization of cost transparency, and supplier benchmarking.
- Well-structured negotiation, preparation and execution.
- “Should Cost” modelling, to provide a sound basis for price reduction requests.
- Finding the optimal balance between BCC sourcing and supplier localization. For many commodities, significant cost optimization potential exists but local sourcing could reduce supply chain complexity, minimize the impact of taxes and duties, or enable better quality management.
- Rigorous contract enforcement, including index-based pricing to leverage a decline in raw materials markets.

Exhibit 4: Improvement levers for holistic value sourcing



Source: Oliver Wyman

Additionally, optimizing the supply chain process (for example, by revisiting a make-or-buy decision or by supply chain disintermediation) yields substantial opportunities for both cost and risk optimization.

Often, large saving potentials exist in categories that are not getting a high degree of management attention, such as C-parts, packaging, shipping or indirect materials.

Successful automotive suppliers implement state-of-the-art methods, processes, and tools, such as systematic evaluation of supplier risks and clearly defined mitigation strategies. Other innovative methods include leveraging enterprise resource planning (ERP) systems for supplier databases and supplier portals, e-tendering, and reverse auctions.

The people who are involved in the sourcing process are key. A further success factor lies in improving their skills by providing a regular feedback process for the entire staff, as well as using comprehensive training catalogues and individual training.

Buyer-supplier relationships are critical: too weak and they increase the risk of missed opportunities; too strong and they might leak cost-down performance. Suppliers should therefore systematically disrupt these relationships, for example through regular staff rotation which in turn enables the systematic transfer of competency.

The impact of such levers is very company-specific. At Oliver Wyman, we usually require a two-week diagnostic “deep dive” to analyze spend data, understand the client’s sourcing approach and organization, as well as the sourcing environment. This is the basis to come up with specific and quantifiable opportunities for optimizing sourcing costs.

Taking advantage of disruptions in the supply chain is a major factor in successfully optimizing costs, quality, and risks: New components that need to be sourced, new vehicle models that have to be supplied, recent production footprint migration, and new company ownership. These all create trigger points for revisiting the supplier relationship, even during ongoing contract periods.

Support from external partners in such a cost reduction initiative can be useful strategically, not only by bringing in best practice methodology and access to new suppliers, but to create disruption. These partners may lead painful renegotiations with suppliers, enabling buyers and the CPO to keep the relationship with the supplier. Furthermore, over the course of such an initiative, the suppliers' purchasing teams will learn from new methodologies and be coached in order to continue these cost reduction exercises on an ongoing basis. This will help to make cost savings sustainable.

EMBED VALUE SOURCING ACROSS FUNCTIONS

Functional excellence is the bedrock of procurement optimization. However, it is essential to fully embed value sourcing practices into the company's strategic decisions and value-creation model.

This means anchoring the purchasing strategy with the overall company strategy, and aligning and monitoring its implementation across all business units and locations. Sharing multiyear performance objectives with other departments secures the close involvement of CEOs or CFOs (or both) and management buy-in throughout the company.

Talent rotation between functions also ensures that purchasing employees exchange expertise and competencies with engineering, production, quality management, and various parts of the organization. Therefore, purchasing roles and responsibilities need to be aligned with other departments to enable collaboration and knowledge transfer across units and functions. Processes need to be set up to systematically make the best use of the group's purchasing abilities, for example in cross-functional responsibilities for requests for information (RFI) and requests for proposal (RFP) processes as well as performance measurement and supplier management. Finally, this transformation means that companies need to integrate their purchasing systems and tools into a company-wide landscape, accessible to their entire organization.

Many companies have not yet succeeded in aligning purchasing with other departments along their value chain. However, such cross-functional collaboration and coordination of all sourcing-related activities across global units is a key driver for leveraging cost, risk, and growth. Encouraging this type of collaboration between departments lets a company tap into additional value, typically leading them to identify even more sophisticated improvement levers. These include:

- Product cost reduction in early stages of the design cycle, such as reducing or substituting material.
- Sourcing-driven design changes, such as SKU consolidation, selecting material based on cost, availability (sourcing power), costs of spare parts and servicing, and supplier risk.
- Reduction of complexity in production and supply chain processes.
- Directed tier-n supplier sourcing.
- Early assessment and revisiting of make versus buy.

Oliver Wyman's proven approach to a cross functional purchasing transformation is centered around the following success factors:

- Aligning stakeholders around ambitious multiyear objectives.
- Cross-functional collaboration in project mode and category-based work streams.
- Applying a comprehensive set of levers for performance and capability enhancement, from transactional quick wins to sustainable long-term potential.
- Deploying modern, integrated performance metrics, for example to track savings, budgets, and impact on profit and loss.
- Changing the system and behaviors along the way.

Transferring the external expert’s know-how to the internal team is crucial to sustain the impact of a purchasing optimization project. When working with clients, Oliver Wyman typically conducts sourcing optimization projects in “waves”: The first wave focuses on pre-defined commodities to showcase the application of identified levers and to develop corresponding tools. The second wave applies the levers, and initiates the adaptation of behaviors and usage of the tools. Subsequent waves are executed by the client and coached by the external expert.

DESIGN THE OPTIMAL SUPPLY SYSTEM

Automotive suppliers need to move beyond identifying quality enhancements and cost-saving opportunities at their suppliers. Attaining substantial performance improvements requires companies to go on a transformational journey that enables a comprehensive view on their supply chains as well as a deep understanding of the interconnections between them. This journey creates competitive advantages and includes important strategic considerations, such as:

- Identifying strategic suppliers with which to foster and intensify collaboration.
- Optimizing the supplier footprint and making the most of BCC sourcing opportunities.
- Managing risks and quality performance holistically across the supply chain.
- Improving costs and risks jointly with the supplier.

By considering the entire supply system rather than simply focusing on itself, a supplier can realize something that goes beyond savings and risk reduction, namely growth. Such supplier-driven growth opportunities result from external innovation, accelerated go-to-market time, and support with international expansion or the development of new products and services.

Even established, successful companies often do not make full use of the potential for external ideas to create competitive advantages. Typical hurdles include the lack of an overarching strategy, the resources, and the right culture to foster open innovation. To change this, top-managers need to rethink their company’s approach to sourcing, ideally through dedicated innovation teams as well as regular communication with suppliers to identify and develop improvement ideas.

They also need to establish new forms of collaboration that not only go beyond suppliers and academia but also make good use of digital platforms. The digitalization of industry provides a significant value lever for smart procurement, supply chain integration, and outsourcing, including the following:

- Better transparency on spend and analytical capabilities.
- Data-driven, automated operational purchasing.
- Real-time inventory and lead time monitoring.
- Broader supply base through easy exchange of digitalized models and new quality systems.
- More flexible outsourcing to third party manufacturers, for example via capacity brokers.

CASE STUDY

PURCHASING TRANSFORMATION

CLIENT SITUATION

The client, an automotive supplier, was facing a typical situation: Deteriorating margins were creating high pressure to reduce costs. Also, traditional optimization solutions were no longer providing substantial savings.

PROJECT OBJECTIVE

The client wanted not only to significantly reduce purchasing costs but also to systematically transfer purchasing expertise to other parts of the organization. Oliver Wyman supported an eight-month project geared towards meeting aggressive shareholder profit expectations, ensuring sustainability, and achieving continuous improvement.

METHOD AND OUTCOME

PHASE 1: REALIZING INITIAL SAVINGS

We conducted a holistic, cross-functional “product cost down” initiative for existing products, using untapped cost drivers such as specifications and functional integration. This quickly delivered results and started to change the overall organization’s mindset.

PHASE 2: ENABLING THE ORGANIZATION

We defined and implemented organizational adjustments, including a cross-functional sourcing process interlinked with existing offer, design, and development processes. Purchasing became strictly organized along commodities. Multifunctional teams were formed for supplier qualification, development, improvement, and risk management.

PHASE 3: MAKING IT SUSTAINABLE

Together with the client, we developed a new product innovation approach (which traces its origins to the space industry) to significantly reduce costs and attain sustainable competitiveness. Reviewing functional specifications, learning from other industries, and creating joint value with suppliers resulted in disruptive cost-saving changes. This enabled the organization to identify a vast array of additional cost-reduction measures with different impact and implementation scenarios.



JOINT VALUE CREATION: IMPROVED COLLABORATION UNLOCKS HIDDEN POTENTIAL

Our experience suggests that a more holistic consideration of supply chains and, in turn, deeper, closely aligned collaboration with suppliers can unlock hidden value potential. Automotive OEMs or IT giants such as Apple and Samsung, which rely heavily on external value creation, showcase best practice on how to create joint value potential with their suppliers.

The keys to success here are:

- Systematic communication and information exchange.
- Synchronization of processes.
- Continuous supplier development.
- Execution of joint improvement activities.

SYSTEMATIC COMMUNICATION AND INFORMATION EXCHANGE

Systematic communication and information exchange with suppliers generates trust and builds relationships. Sharing detailed volume forecasts, and committing to those volumes, improves suppliers' ability to adjust capacity levels, minimize costs, and meet quality targets. However, information needs to be exchanged selectively and in a structured way, especially in the early stages of product development.

SYNCHRONIZATION OF PROCESSES

Synchronizing and optimizing end-to-end supply chain processes, while taking into account the business requirements of both customer and supplier, is another important way to improve supply chain performance and costs. For example, harmonizing order cycles could reduce logistics costs and improve the working capital of suppliers. Another opportunity lies in reducing multiple measurements of the same quality parameters, for instance at supplier as well as at customer sites.

CONTINUOUS SUPPLIER DEVELOPMENT

Best-practice manufacturers develop their suppliers' capabilities and teach them how to optimize production processes, manage inventory, and improve the engineering process. Guest engineer programs could help to exchange best practice and transfer knowledge, particularly from the manufacturer to the supplier.

EXECUTION OF JOINT IMPROVEMENT ACTIVITIES

Joint improvement activities help unveil tremendous value-creation potential. By conducting joint workshops (with production, supply chain, commercial, purchasing, quality and logistics teams), companies can identify supply chain inefficiencies and optimization levers. Tools such as process mapping, data analysis, benchmarks, and joint brainstorming sessions can all contribute. The impact of different levers can be assessed by the potential for both parties to achieve better margins. Using an external moderator for these activities could help to provide a common analytical basis, introduce the parties to external benchmarks, moderate workshops, and allow them to holistically assess the potential for joint margins.

Realizing such joint value potential requires a cross-functional willingness to engage in structural transformation and fundamentally change relationships with suppliers.

CONCLUSION

In the face of multiple market challenges, automotive suppliers need to rethink their purchasing performance and operating model. The level of maturity and sourcing performance is already high in the industry. However, to create value, suppliers need to become more sophisticated and be even better at sourcing, especially as they capture a larger and growing share of automotive value creation.

Identifying and consequently implementing the right levers to improve the purchasing function's performance is an important but basic step. The most common mistake is to think of purchasing as an issue for a single functional division rather than as an extended system that integrates business units, finance, and purchasing. Cross-functional levers need to be pulled, for example disruption to drive down product costs in the early stages of the design process, and performance needs to be driven by all stakeholders – developers, users, and buyers – through direct senior management sponsorship.

Finally, the entire purchasing ecosystem needs to be reviewed. It should be synchronized in a digital environment, so it can be used to create joint potential for improvement and to implement any opportunity that emerges, be it a higher margin, better quality, reduced risk, or a way to enable mutual growth. Automotive suppliers need to start this transformational journey today so they can cope with upcoming challenges and create real value through the sourcing process.

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Oliver Wyman is a global leader in management consulting. With offices in 50+ cities across 26 countries, Oliver Wyman combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation. The firm's 4,000 professionals help clients optimize their business, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is a wholly owned subsidiary of Marsh & McLennan Companies [NYSE: MMC]. For more information, visit www.oliverwyman.com. Follow Oliver Wyman on Twitter@OliverWyman.

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Oliver Wyman's Automotive Supplier Team is the sole consultancy dedicated to total supplier excellence. Our team consists of experts in strategy development and implementation, sales, development, purchasing, supply chain management, production as well as EBITDA improvement, restructuring and M&A in the automotive supplier industry.

To highlight key trends, strategies and implications, Oliver Wyman is publishing a series of articles focused on major functional areas that are facing a strong necessity for fundamental change, including footprint, engineering, organizational excellence, restructuring, and purchasing.