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New White Paper from ISG & GEP

Speed, Agility and Muscle:

The Rise of Procurement Outsourcing in
the Results-Driven Enterprise



Executive Summary

With long-term economic and revenue trends uncertain, both the board room and C-suite are counting on the procurement organization to help deliver the next level of operational and cost efficiencies.

To accomplish this, innovation is required. Easier said than done – where exactly will practical, effective procurement come from? Whatever the answer, most certainly an enterprise's procurement leadership is ultimately responsible for bringing innovation to bear and for the results it produces.

We believe that external procurement service providers will carry a significant share of responsibility for introducing innovation to enterprise clients. In fact, in a recent study of enterprise procurement professionals, 51% of the survey respondents said external sources, such as service providers, are expected to help catalyze procurement innovation. ¹

Our research points to five absolutely critical results-drivers.

- 1) Fast Impact (that is, compressed time to value)*
- 2) Improved real-time visibility into and control of spend under management
- 3) Increased emphasis on collaboration and superior customer service
- 4) Enhanced focus on compliance and risk management, especially in highly regulated industries
- 5) Greater efficiencies in procurement operations, with enhanced reach and scope

* Cost reduction, while part of the value component is one element of total procurement value, while quality and functionality are also critical

The rise of the procurement function to greater prominence within the enterprise, like many ultimately positive phenomena, does bring pressure. The operation itself is under greater scrutiny. Not necessarily a bad thing if it drives gain.

High Expectations, Flat Budgets

Companies are seeking more aggressive savings from procurement. These savings can come from cost reductions, greater operational efficiency and improved cash management, but come they must.

What's more, the expectation among many in corporate leadership is to achieve these results quickly and with little (or no) incremental cost.

Indeed, a recent Hackett Group study shows that procurement operating budgets and staff FTEs have actually decreased in 2013 as compared to 2012. Operating budgets have decreased by .40% and staff FTEs have decreased by .50%². While these reductions seem small, they are significant as workloads and throughput are continually increasing.

Many procurement organizations are struggling to simply sustain the support necessary to meet the demands of internal customers – this while monitoring regulatory changes, managing supplier risk and controlling costs.

In our analysis, few internal procurement organizations will be able to secure the funding necessary accomplishing everything on their plate. That includes increasing their talent and skill base, training staff, investing in tools and technology, and enhancing their contract governance capabilities.

In fact, the very availability of skilled procurement talent continues as a chronic limitation. The talent shortage is especially apparent at the middle management level. In addition to process expertise and category expertise, this layer is critical to program implementation, compliance and governance, and change management.²

At present, a number of well-know CPOs at leading global enterprises are re-thinking long-held assumptions as to the limits of the procurement function and organizational structure – pushing more aggressive goals, moving into business strategy and planning, and organizing hybrid operational teams with expert providers to maximize their internal group's reach, scope and impact.

As a result, these procurement leaders are expanding the use of third-party procurement service providers (PSP).

By leveraging a PSP, procurement organizations can immediately avail themselves of a deep range of expertise and existing infrastructure that can impact immediate and provide increased benefit to the entire enterprise. This is particularly evident in the indirect, or non-core, procurement space.

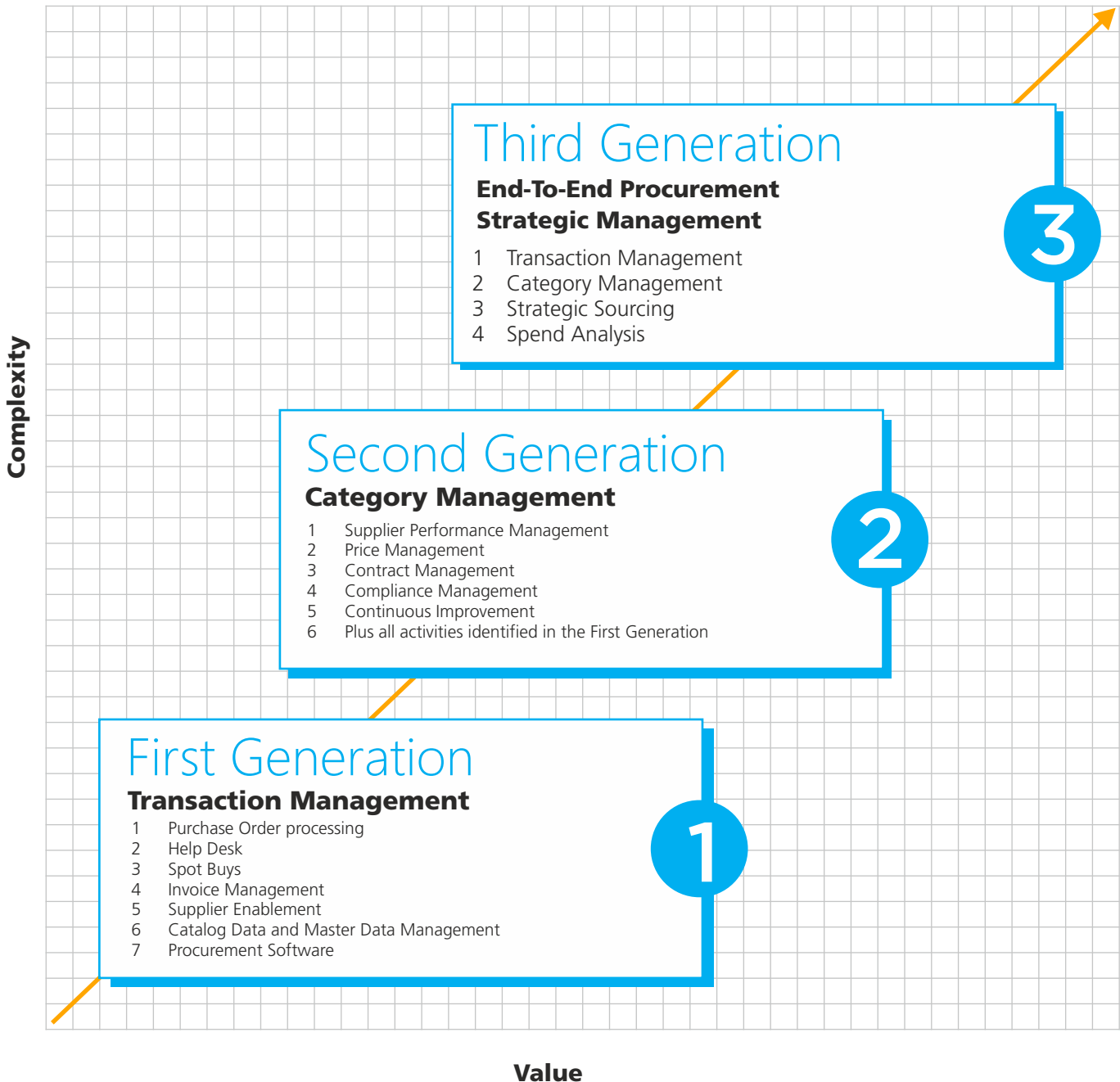
Typically, between 20-35% of an average company's revenues are allocated to non-core purchases. This includes spend that is not a direct input or component of the final product/service being offered. This non-core spend can be very significant, however, it is often under-managed, compared to its "core-spend" (or direct material) counterpart, due to a number of challenges. These challenges include lack of focus on non-core spend categories, lack of standardized specifications, high fragmentation, and a high rate of non-compliance.

PSPs can help companies mitigate these challenges by immediately leveraging an infrastructure that focuses on non-core spend and leverages category specific expertise, strategies and processes.

Procurement Service Providers & the Evolution of Procurement Outsourcing

The capabilities of PSPs have expanded considerably over the last ten years. Each generation has evolved as complexity of delivery and impact to overall value has increased.

The three “generations” of the procurement outsourcing evolution are as follows:



Industry leaders, who engaged in first-generation activities, are now moving towards second- and third-generation initiatives. These next-level initiatives leverage a procurement service provider's capabilities to address the procurement process holistically.

Market Trends

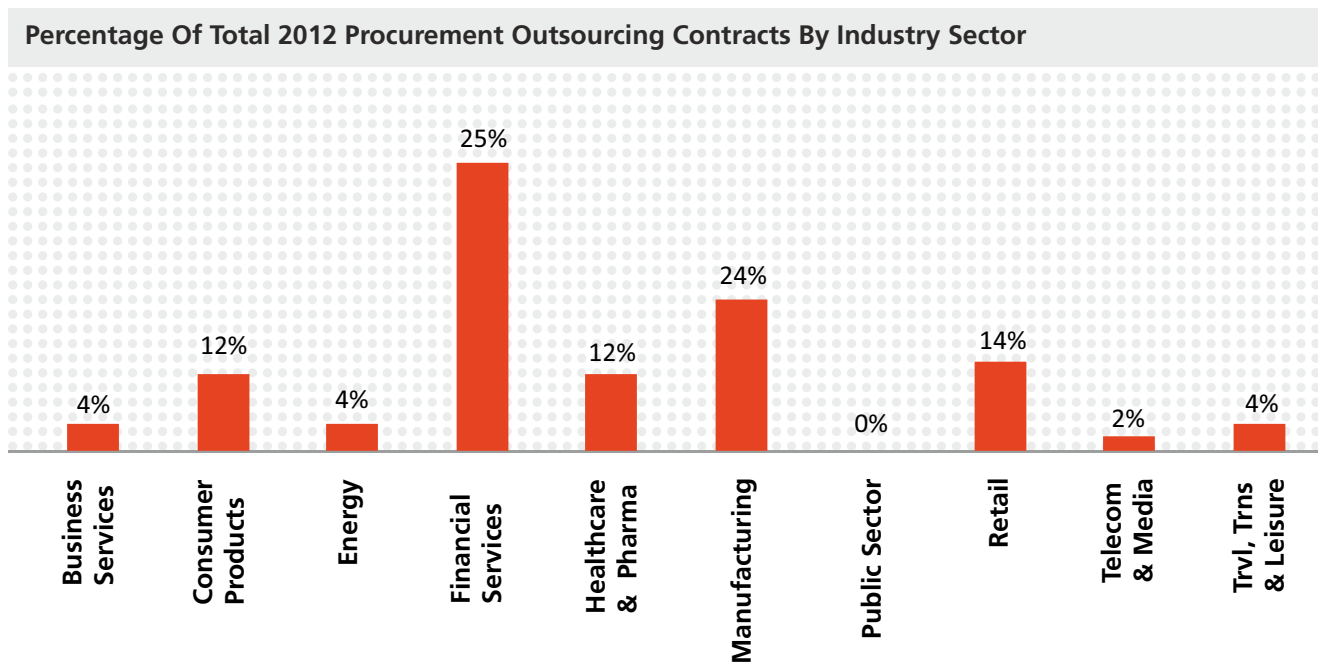
Since 2007, the procurement outsourcing market has experienced double-digit annual growth in total contract value (TCV). In 2012, this trend continued with an annual growth rate of approximately 10%. ISG believes the industry should see growth accelerate over the next several years.

The adoption of procurement outsourcing is evident across nearly all industries and sectors. The chart below depicts the share of various enterprise categories as a percentage of total 2012 procurement outsourcing contracts.

Financial services and manufacturing lead most other industry sectors in leveraging PSPs.

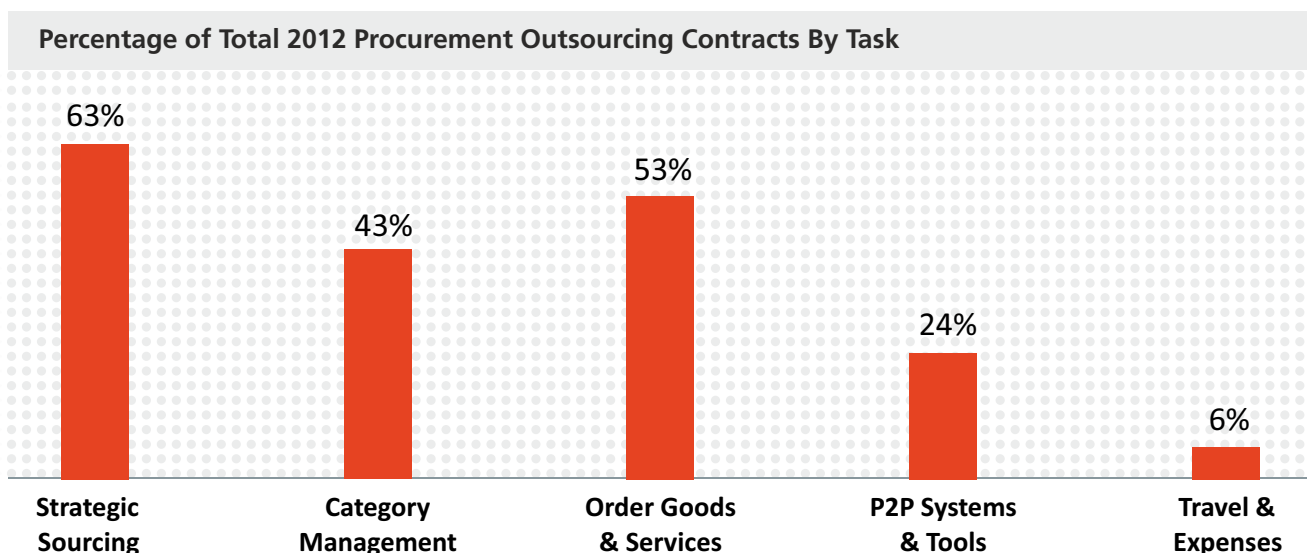
One of the motivating factors in the financial services sector is the growing global regulatory requirements for financial services firms.

These regulatory requirements are placing a significant burden in the form of demonstrating controls and reporting on the management of their supply chains. This reporting is driving headcount spikes and financial service firms are looking to lower these costs – partly through technology and partly through PSPs.



In manufacturing, the focus typically tends to be on creating and investing in a supply chain organization targeting raw materials and direct inputs. As a result, the manufacturing sector has been an early adopter of procurement outsourcing across non-core spend.

On a field level, what work are PSPs actually doing? In 2012, contracts broke up along the following lines:



The data reflects significant focus during 2012 on higher value-added and complex activities such as strategic sourcing and category management. This is clear evidence that an increasing number of companies are moving from first generation to more mature procurement outsourcing initiatives.

Timing is Everything – No, Really

Procurement outsourcing is one tool among many to help enterprise procurement organizations achieve their objectives. When does it make most sense? The answer is in the numbers.

Current procurement activities must be documented, verified and benchmarked for cost and effectiveness. Once this data collection is complete, your team has a set of comparables to apply to the pro forma business cases of procurement service providers.

To achieve the most impressive results, companies need to consider a longer-term (i.e., three- to five-year) perspective on procurement strategy and operations. A long range view and plan – which enables essential value multipliers such as scale and sustainability – see cost decline precipitously after start-up and productivity improve incrementally year after year.

This is absolutely necessary for a reasonable assessment of the impacts of procurement outsourcing, on everything from spend under management to customer satisfaction.



Where does the notion procurement transformation come in?

An expert provider of end-to-end procurement services must operate an efficient, effective global procurement organization to both meet the needs of clients and stay competitive. The fact that a procurement service provider's economic and investment drivers are significantly different than an in-house enterprise team gives the service provider a different perspective and posture on investing in infrastructure, tools, technology and talent. With ROI more rapid, investment risk spread out and the activities in question unarguably at the very core of their enterprise, PSPs worthy of the name, simply have more wherewithal.

While many pragmatically-minded sourcing and procurement professionals are justifiably results-oriented, procurement transformation should, to some degree, be part of what you buy and where you partner with a procurement service provider.

And in terms of the credibility of a provider's claims, it's worth kicking the tires here.

The value you receive as a client is driven by the effectiveness and efficiency of your provider. (Effectiveness involves achieving savings, while balancing supplier performance, process quality and the needs and preferences of internal stakeholders. Efficiency involves process cost, labor productivity and cycle time.)

It is clear to us that companies that do not execute against a long-term strategic plan will leave a significant amount of value on the table.

The quantification of lost savings opportunities will vary from company to company. But affected areas include headcount reductions, inventory reductions, infrastructure cost reduction or elimination, employee training costs to enhance or maintain skills and cash flow.

When to Consider Procurement Outsourcing

Immediately. Why? Because the procurement function, in many companies, is at a critical juncture. Procurement leaders are being asked to deliver more with less. In a shorter period of time. In more complex, interdependent environments. While under severe pressure to innovate, CPOs must determine if they should make or buy the necessary capabilities that they will require in the future.

The trade-off between build costs (hiring new employees, training existing employees, designing new processes and controls, implementing new systems) and buy costs (fees to PSPs) must take into consideration both short- and long-term implications, including speed to impact, operational costs, strategic focus, business agility, risk management, opportunity costs and, of course, hard, cold, actual results.

The time frame for making such decisions in most companies is now, due to several critical driving factors, including:

- 1) Research finds skilled staffers are spending more than 10% of their time addressing tactical, administrative issues or tasks
- 2) Replacements for skilled staffers are not easily found either internally or externally
- 3) Category expertise is required to drive increased spend under management
- 4) Aging software tools provide less efficiencies and fail to meet expectations of stakeholders
- 5) Project delivery dates frequently slip

Many successful procurement organizations are at their maximum capacity, and simply not able to expand – in a sustain way – their scope of work within acceptable time frames. Ultimately, the decision to evaluate procurement outsourcing providers is an affirmative move to enhance internal capabilities, not replace or eliminate them.

Procurement Service Provider – Selection Criteria

While far from all inclusive, the following list is a substantive starting point for identifying and qualifying PSPs for consideration.

One note – Weighting of criterion is an important part of the review framework, but much of the force of sound weighting depends of the individual strategy, culture and objectives of each enterprise.

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|--|----------------------------|
| 1) Capability Assessment | 6) Capacity & Scale |
| 2) Category & Industry Expertise | 7) Financial Stability |
| 3) Change Management Experience | 8) Infrastructure |
| 4) Global / Regional / Key Markets Footprint | 9) Technology |
| 5) Integrated Global Delivery Model | 10) Service Delivery Model |

Conclusion

Pressure is mounting on CFOs, CPOs and other enterprise leaders to achieve greater operational efficiency, expand reach and scope and drive further cost reductions to the bottom line. Stagnant, if not declining, budgets and the need for fast action will force a new hybrid procurement service delivery model.

We believe that procurement organizations will continue expand their perspective, flexibility and capabilities – moving from primarily designing, staffing, operating and managing in-house procurement teams to also designing and managing procurement service providers – to meet their companies operational and strategic procurement needs.

Procurement service providers have in place today the highly trained and specialized staffs, infrastructure, tools, processes and technologies, global footprint, category depth and industry experience to meet their clients' needs for point and end-to-end procurement solutions.

For procurement leaders looking to act quickly and decisively, leveraging an experienced procurement service provider is a truly viable option.

Sources

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- 1 – KPMG – “Global Manufacturing Outlook – 2013”
 - 2 – The Hackett Group – “2013 Procurement Key Issues: Going Deeper and Broader to Deliver Borderless Procurement Services” January, 2013
 - 3 – SupplyChainBrain – “Supply Chain Talent is the Missing Link in the Race for Supply Chain 2020” July 3, 2013



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100 Walnut Avenue, Clark, NJ 07066 | P 732.382.6565 | info@gep.com | www.gep.com

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