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Measurement Revisited and Procurement's Role in Merger Integration

An Executive Summary of the Sixteenth Chief Procurement Officer Executive Roundtable

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Introduction

A.T. Kearney's 16th Chief Procurement Officer (CPO) Executive Roundtable focused on measuring performance and procurement's role in merger integration. Both topics point to procurement's ability to provide value to the organization. Advanced metrics are emerging that show procurement's value in terms that the entire business can grasp. And procurement is being called upon to generate a significant share of mergers' anticipated economies of scale in order to increase profitability and shareholder value.

Measurement Revisited: A New Path to Respect, Stature and Performance

Joe Raudabaugh
President, A.T. Kearney Procurement and Analytic Solutions

Despite some impressive gains in stature as the function has taken on efforts beyond cost control, there is some sense among its practitioners that procurement continues to be thought of in a lesser light than some other corporate functions. A new way to demonstrate the value that procurement generates, in terms that the business—particularly finance—will understand, comes in the form of ROSMA©, Return on Supply Management Assets, which is an A.T. Kearney measurement approach.

More than 30 A.T. Kearney clients are actively seeking to incorporate ROSMA into their measurement strategies in order to discuss procurement performance in more Wall Street-friendly terms and provide visibility into procurement drivers and outcomes. ROSMA allows for the isolation of specific performance areas—be they geographic, category specific or by business unit—by providing definitive metrics for benchmarking real performance results.

ROSMA factors in a range of financial results, including spend coverage, velocity, category yields, compliance and extended benefits—weighing the results against the actual investment made in supply management assets, in order to produce a ratio of results to cost. This metric can demonstrate the effectiveness of the procurement process overall, or it can provide more granular measurements, such as success in a specific category, a special project or with a certain supplier. It can help reconcile financial reporting, develop a framework for discussions with specific internal parties and provide an opportunity to review sourcing plans and cadence, among other potential uses. The ROSMA approach can also be adapted to generate an analysis of the economic value that supply management has added.

Because it includes extended benefits, ROSMA gives insight into the performance of functions that work with procurement, such as operations and accounts payable, whether they are direct actors or influencers. Above all, ROSMA portrays what is actually done in purely economic terms that provide an objective performance snapshot. While it cannot factor in subjective aspects, such as risk management and supply continuity plans, it is still a valuable tool for astute companies to employ in evaluating their performance. Procurement executives who feel that their organizations are underappreciated in the executive suite have much to gain by employing the language, tools and measures of finance, and the transparency they can gain from them.

The Anheuser-Busch InBev Way

Tony Milikin
Chief Procurement Officer, Anheuser-Busch InBev

One key to the success of a merger is the degree to which the two corporate cultures mesh. InBev executive leadership found a good match in Anheuser-Busch when it acquired the company in 2008, as both companies had a strong focus on cost management.

Cutting costs from the newly formed organization has been a priority since the November 2008 incorporation of Anheuser-Busch InBev. In 2009, the company realized $1.1 billion in synergies, reduced its debt, and increased its earnings and gross margins. With strengths in category yields, compliance, net extended benefits and period costs, the company is committed to obtaining a 13 percent annual reduction in non-material and other non-product costs moving forward, a goal that puts pressure on procurement and the entire business for continued success. Employee bonuses hinge on meeting targets.

Anheuser-Busch InBev has a strong finance function and inclination, making A.T. Kearney's approach to measurement, ROSMA©, an ideal fit to serve as a procurement productivity index. ROSMA, which stands for Return on Supply Management Assets, helps identify gaps and creates a burning platform for closing them. While the company emphasizes frequent sourcing efforts, or velocity, it believes that it can improve in this area and supplier innovation, which may prove critical to growing the top line.

As the single largest buyer in its key spending categories, Anheuser-Busch InBev believes that its suppliers will benefit by adopting the same high-pressure corporate culture that drives its own continuous savings program.

While most companies do one thing well, Anheuser-Busch InBev is intent on mastering every aspect of the brewing and branding business. This means hiring and retaining people who have a knack for making things happen by working within and outside of the business. It means taking advantage of the company's huge scale and pursuing joint ventures in areas such as indirect purchasing. A constant willingness to learn new sourcing techniques and tools is a must. As the integration process continues and deepens, the company continues to emphasize the need to include members from both predecessor companies on all project teams. Above all, the company continues to measure the success of all of its efforts and correct any identified shortcomings.

Anheuser-Busch InBev believes that its suppliers will benefit by adopting the same high-pressure corporate culture that drives its own continuous savings program.

Roundtable Discussion

Moderator: Tim MacDonald
Partner, A.T. Kearney

The need to increase procurement's credibility and visibility, improve communications and identify performance gaps created the impetus for ROSMA©. Along with income statements and balance sheets, the findings from a ROSMA analysis create a more holistic view of the organization's performance against plan. The savings achieved in specific categories are easier to track and communicate when run through this model. With the CFO and finance team engaged, procurement's numbers gain additional credibility throughout the business.

Companies that employ ROSMA typically have processes in place to adjudicate and validate savings achieved through procurement, which makes adopting this model a smaller step for them.

ROSMA has uses beyond the executive management team. General managers with profit-and-loss responsibility can also benefit from it as they endeavor to meet corporate strategies. Once gaps are identified, they can better understand the need to release resources to work on cross-functional sourcing efforts. ROSMA can also illustrate the gap between user spending and procurement-led spending to demonstrate the superior results achieved by procurement. As one roundtable participant observed, "Procurement is one of the rare professional disciplines that is frequently carried out by non-practitioners, typically with diminished returns."

ROSMA not only enables the optimization of procurement's pursuit of savings by addressing spend coverage and governance, velocity of negotiations, effectiveness of sourcing strategies applied, among other areas, but it specifically provides for recognizing the value from innovation and growth derived from suppliers affected by the supply organization.

At the same time, procurement's ability to contribute to the top line in the current economic climate is not being exploited in many instances, despite the fact that sourcing brings reduced results in most categories with each successive wave. Management is most concerned with the bottom line at present; a "one-enterprise" approach is being emphasized to maximize bottom-line performance. Reciprocal buying arrangements may appear to be a way of growing the top line, but these are typically made with reduced leverage—indeed, in some instances procurement is left out of such talks entirely, leading to purchases at cost levels that would not ordinarily be tolerated. Antitrust concerns are another reason to be cautious about reciprocal buying.

Procurement's Role in Innovation: Survey Discussion

Mike Hales
Partner, A.T. Kearney

As suggested by the findings from the brief innovation survey that roundtable participants completed, while every company craves innovation, there is some confusion about how to define it and many questions about how it can be brought in from the outside. Procurement has gained traction as an active driver of innovation efforts; LG in particular has demonstrated that, according to a recent *BusinessWeek* study. The link between procurement and innovation is clear, but questions remain around how companies can make this potential connection happen.

There is little consistency about what tools or techniques procurement organizations are employing to achieve innovation. The most common include joint supplier innovation, innovation sourcing and periodic innovation events. Dedicated innovation-focused websites, training and staff, and innovation-based performance management are rarely utilized but could prove fruitful.

In terms of the typical five-stage innovation cycle, procurement is most heavily involved on the back end, during commercialization. While this is unsurprising in light of the need to find sources of supply to produce new items, it is somewhat unexpected considering the hype around procurement's ability to get suppliers involved with innovation efforts—suggesting again much uncertainty about how to innovate. While half of respondents noted that procurement has some involvement at the idea-generation phase, it is unclear how much the function contributes at this stage. Procurement, marketing and sales all have the external touch points to bring innovation from the outside, though few metrics are in use to measure supplier innovation.

Respondents cite a number of barriers to innovation that they face both within and outside procurement. Limited resources, a lack of metrics and supplier incentives, too little cross-functional collaboration and too few innovation targets and objectives were most frequently mentioned. Some innovation-related metrics that participant companies use include revenue growth tied to specific innovations (new products) and cost avoidance brought about through innovation.

Procurement has the will and should develop the skill to bring a major impact to companies' innovation efforts. Many are beginning to segment suppliers with innovation in mind as part of their initial open-innovation efforts. Procter & Gamble, for example, has done this to significantly increase its percentage of innovations in recent years. Suppliers are generally divided into two camps: a relatively small number of companies that can be approached in a collaborative way and those that will continue to be sourced competitively. Each type of supplier will work through distinct interfaces from the buying company; top-to-top relationships are needed to provide proper oversight and governance and drive innovation ideas through to fruition.

Open innovation and the abandonment of a "not-invented-here" attitude are musts as internal research-and-development departments alone cannot meet companies' growth objectives.

Procurement's Role in Merger Integration

Mike Wise
Partner, A.T. Kearney

After examining approximately 300 recent corporate mergers and acquisitions (M&A), A.T. Kearney came to a sobering conclusion: Only rarely does M&A activity create significant shareholder value or improve profitability. The average merger sees the acquirer's value grow by 2.8 percent; three years after an acquisition only 29 percent of companies show margin increases, while 57 percent actually show reduced profitability.

As important as screening acquisition candidates, negotiating and closing the deal are for executing a merger, the strongest success factors are the upfront strategy and the actual merger execution period prior to and after integration. Because market expectations are invariably high, swift payback in terms of cost synergies is required. In our experience, procurement typically delivers more than one-third of the overall synergy cost savings, with an especially deep impact in the first year of the post-merger integration period. While procurement benefits from an increase in the size of its addressable spend and new opportunities to take advantage of scale, it also has to work through the pains associated with a new organization and new suppliers. Procurement also tends to face additional pressures to achieve months into the merger when other parts of the business fall behind their savings goals.

While the typical merger takes anywhere from one quarter to seven months to close following the intent-to-merge announcement, "clean-room" work with third parties can and should begin as soon as the announcement is made, in order to maximize merger benefits. At minimum, the clean teams can begin data collection that will provide instant manageability of the business upon closure. A synergy assessment in tandem with this data collection can define improvement measures. To maximize clean team benefits, a full-fledged merger-planning effort can establish key infrastructure items such as processes and organizational design.

Clean teams accelerate synergies by months and also generate more synergies than waiting until the merger closes. In the pre-closing environment, they help to focus on and define how value will be delivered. They also carry the added benefit of capturing institutional knowledge before the resource cuts and attrition that accompany a merger consolidation begin.

Because 85 percent of synergies are captured in the first year after a merger closes, any work performed ahead of close ushers in benefits as quickly as possible. Examining contracts in advance will help map out solutions ahead of close; analyzing the entire supply chain will help determine how best to rationalize the production network. Other keys to success include maximizing procurement's role by remaking sourcing plans in each category and working procurement into the mix of every function and business unit's plans to help them meet their targets.

Beyond the presumed economies of scale and benefits of a larger spend pool, procurement also brings value through everyday endeavors such as strategic sourcing and specification standardization.

Merck Global Procurement

Richard Spoor
Senior Vice President of Global Procurement, Merck and Company

Pharmaceutical company Merck had many reasons for pursuing its 2009 merger with Schering-Plough, including complementary products, an enhanced portfolio of products in development, an expanded global presence, synergies and talent. Procurement at both companies had a significant role in capturing the savings from the new synergies, and worked in a clean room that allowed the merging parties to share significant amounts of data ahead of closing. A "fast start" program was also put into motion to build major suppliers' awareness as to how the new organization would work.

Of Merck's 650 procurement personnel, half reside in the United States while the rest are dispersed across 30 different international markets. An additional 150 employees not yet included in the function's headcount have procurement as their primary responsibility. The fully integrated organization spends nearly $16 billion for research, manufacturing, shared services, information technology and marketing. Well over half of this spending occurs in North America.

Merck global procurement has committed to delivering more than $1.4 billion in savings to the company through 2012. The majority of this amount represents savings that would not have been possible without the merger.

The new global procurement organization is designed to provide a sustainable procurement capability that will build internal business partner relationships in order to influence the vast majority of the company's spend. Managing supply risk and exceeding synergy savings expectations are at the top of Merck's agenda for the new organization, along with global performance and supplier diversity. Priorities for this year include maximizing synergy savings, completing implementation of the enterprise resource planning (ERP) system, and bringing the two supply organizations together into a high-performance function with the right capabilities. All procurement employees participated in a new sourcing management training program in order to implement a single sourcing methodology across the organization.

> *Merck global procurement is committed to delivering more than $1.4 billion in savings to the company through 2012.*

The company is also emphasizing business continuity, which requires supplier risk mitigation for both direct supply and clinical research services. Improved knowledge of supply market dynamics and supply base composition will build risk awareness across procurement. Select partnering activities will help mitigate critical supply issues and maximize synergy savings while steering clear of supply disruptions that can erode synergy-related benefits.

To accelerate value capture, Merck has more than 70 sourcing wave teams. Fast-start negotiations laid out the parameters for new three-year deals with key suppliers. These negotiations were followed by quick-win efforts during the six-month period following merger close, and then more traditional cross-functional strategic sourcing efforts. Every spend category was addressed through these efforts, coupled with aggressive demand management.

The seeds are in place for Merck to build larger relationships and consolidate the supply base for cost advantage coupled with supply assurance, quality, service and innovation. The company has also introduced a new end-to-end, source-to-settle process with its recent ERP implementation.

Merck considers this pre-close planning work as key to the merger's success to date, both for the analytical work it performed and the relationships developed. Common sourcing gave clear direction upon closing, with fast-start discussions with key suppliers paying quick dividends. By mapping the new organization in advance, the skills and knowledge of every member of the procurement team were maximized and people were kept engaged.

Roundtable Discussion

Moderator: Tim MacDonald
Partner, A.T. Kearney

While there is no exact formula for merger success, perspectives are emerging around the importance of procurement strategy, organization and execution before, during and after a merger's close. The culture of the acquired company must always be addressed, either for compatibility or malleability. Where commonality is lacking, change will have to be introduced. As one participant says, "Being acquired is a miserable place to be."

The clean room work performed between the announcement of intent to move and the actual closing provides a tremendous opportunity to position the merger for success. Mapping both companies' current environments and discussing the target environment shows where changes must be made in the short and long term. Common sourcing footprints lead to sourcing synergies. When processes are standardized ahead of time, the merger has a greater chance of success. At the same time, caution is warranted when acquiring companies in emerging markets, as their processes and practices tend to be complicated. While it is tempting to standardize, care must be taken not to lose sight of the requirements of the local supply base and marketplace.

Synergy-related sourcing savings represent a significant part of the initial value found in most mergers. Interestingly, acquiring companies often learn that volume is not everything as they work through contracts and discover that the acquired company was receiving superior pricing for some supply—which provides an opportunity to add to the incremental savings in a merger.

A key decision that companies may revisit after a merger is at what level a category should be sourced: locally, regionally, internationally or globally? The higher the level, the fewer resources typically required to manage it. But there are many caveats around global category management, including the need to understand where the spending is, what relationships need to be managed to secure supply in each geography, and the practical implications of doing so, such as the effect that supplier consolidation might have on service levels. Each category typically needs to be managed at a different level.

A merger's effect on key supplier relationships varies tremendously from situation to situation. Some become more important, while others devolve into standard buyer-seller agreements as the mix of collaborative and competitive relationships changes to meet the merged company's realities. The acquiring company's key suppliers are more likely to retain their elevated status than the company it purchased, due to cultural alignment and other factors. Because the run-up to a merger typically finds key resources working more creatively than normal, new and intriguing scenarios around supplier relations can be explored.

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