Sourcing Strategies

Milan Kumar

IIM Viskhapatnam

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Learning Objectives of the Session

1. Roles of Outsourcing and Procurement in the supply chain
2. Make or Buy decision
3. When to Outsource?
4. Procurement Strategies

Introduction

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  - Electronics Industry
    Cisco (major suppliers across the world)
    Apple (over 70% of components outsourced)

Make Or Buy

Benefits of Outsourcing

- Economies of scale
- Risk pooling
- Reduce capital investment
- Focus on core competency
- Increased flexibility

Risks of Outsourcing

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- Conflicting Objectives

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Risks of Outsourcing contd..

Conflicting Objectives

- Demand Issues
- Product design issues

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Conflicting Objectives

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  1. In a good economy
     i. Demand is high
     ii. Conflict can be addressed by buyers who are willing to make long-term commitments to purchase minimum quantities specified by a contract
  2. In a slow economy
     i. Significant decline in demand
     ii. Long-term commitments entail huge financial risks for the buyers
- Product design issues

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- Product design issues
  1. Buyers insist on flexibility
  2. Suppliers focus on cost reduction

Outsourcing Problems: IBM

- PC market entry in 1981
- Outsourced many components to get to market quickly
- 40% market share by 1985 beating Apple as the top PC manufacturer
- Other competitors like Compaq used the same suppliers
- IBM tried to regain market by introducing the PS/2 line with the OS/2 system
  - Suppliers and competitors did not follow
  - IBM market share shrunk to 8% in 1995

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  - How can the firm identify what is in the core?
  - What is outside the core?

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  2. For various reasons decides to outsource
- Dependency on knowledge
  1. Firm does not have the people, skills, and knowledge required to produce the component
  2. Outsources in order to have access to these capabilities

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- Vehicle electronic systems
  - Designed and produced by Toyota's suppliers
  - Company has dependency on both capacity and knowledge

Outsourcing Decisions at Toyota contd..

- Toyota seems to vary its outsourcing practice depending on the strategic role of the components and subsystems
  - The more strategically important the component, the smaller the dependency on knowledge or capacity

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- Modular product
- Integral product

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Hierarchical Model for Outsourcing Decisions

- Customer Importance
- Component Clockspeed
- Competitive Position
- Capable Suppliers
- Architecture

Examples of Decisions

Criteria	Example 1	Example 2	Example 3	Example 4
Customer Importance	Important	Not important	Important	Important
Clockspeed	High	Slow	High	Slow
Competitive Position	Competitive Advantage	No advantage	No advantage	No advantage
Capable Suppliers	X	X	Key variable to decide strategy	
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Procurement Strategies

Procurement Strategies

- Impact of procurement on business performance 2005 profit margins for Pfizer (24%), Dell (5%), Boeing (2.8%)
- Reducing procurement cost by exactly 1% of revenue would have translated directly into bottom line, i.e., net profit.
- To achieve the same impact on net profit through higher sales
  - Pfizer would need to increase its revenue by 4.17 (0.01/0.24)%
  - Dell by 20% and Boeing by 35.7%
- The smaller the profit margins, the more important it is to focus on reducing procurement costs.

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  - What are the drivers of effective procurement strategies?
  - How can the firm ensure continuous supply of material without increasing its risks?

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  - supply risk: Availability/number of suppliers/competitive demand/ make-or-buy opportunities/ storage risks/ substitution opportunities

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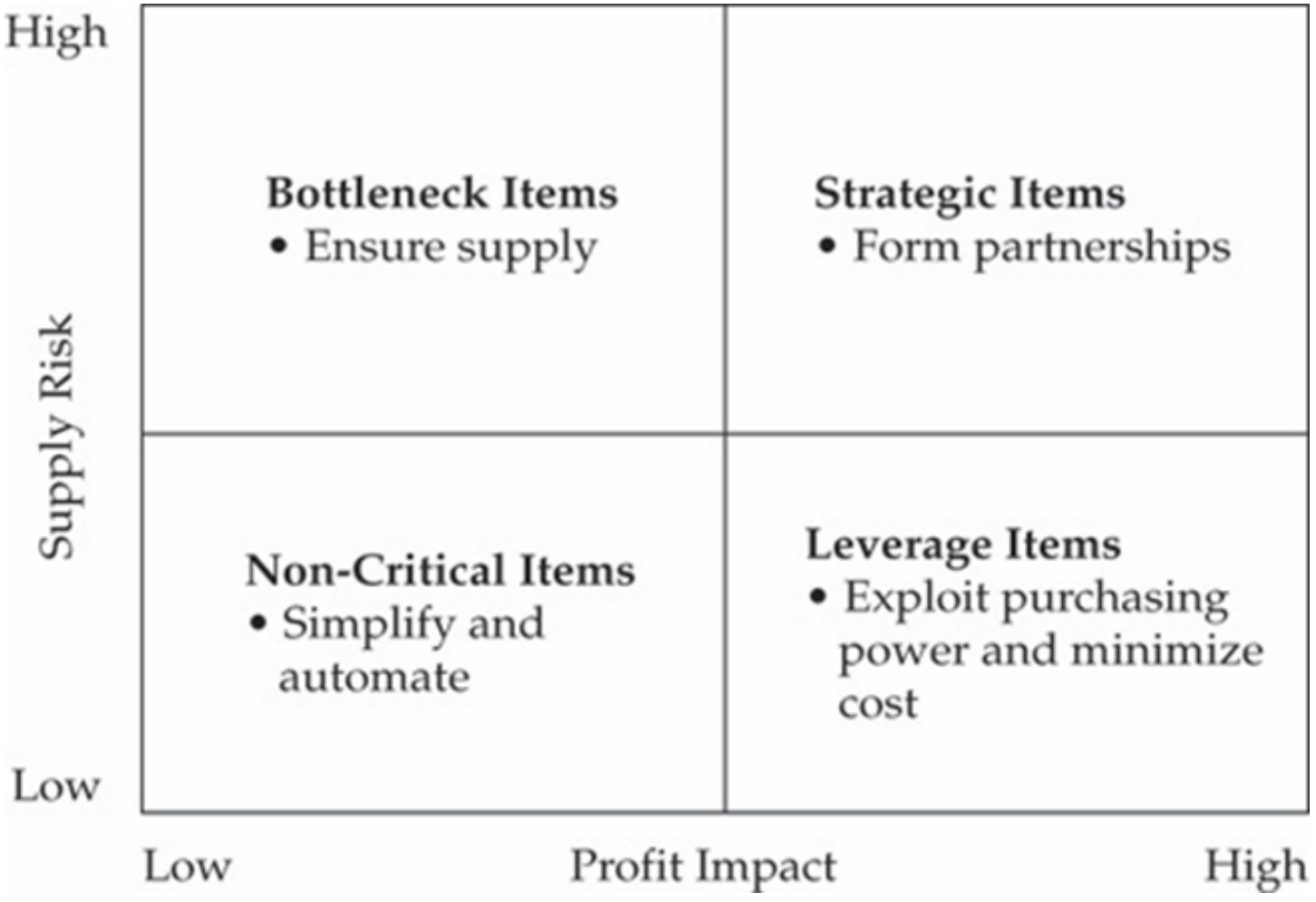

Figure 1: Kraljic's supply matrix

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Fisher's Supply Chain Matrix

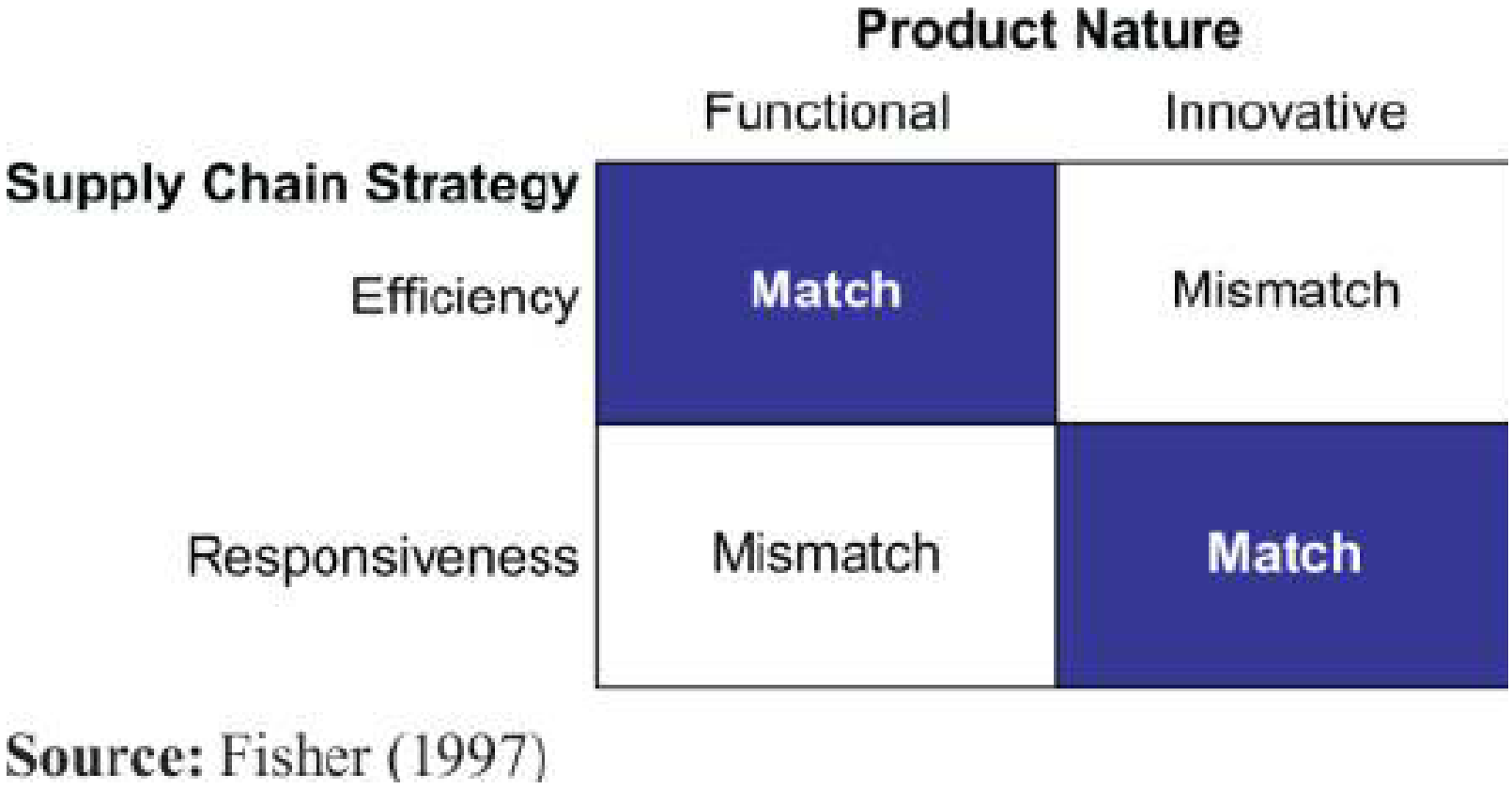

Figure 2: Fisher's Framework

Integrated Framework

- Component forecast accuracy
- Component supply risk
- Component financial impact
- Component clockspeed

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Qualitative Approach to Sourcing Strategy

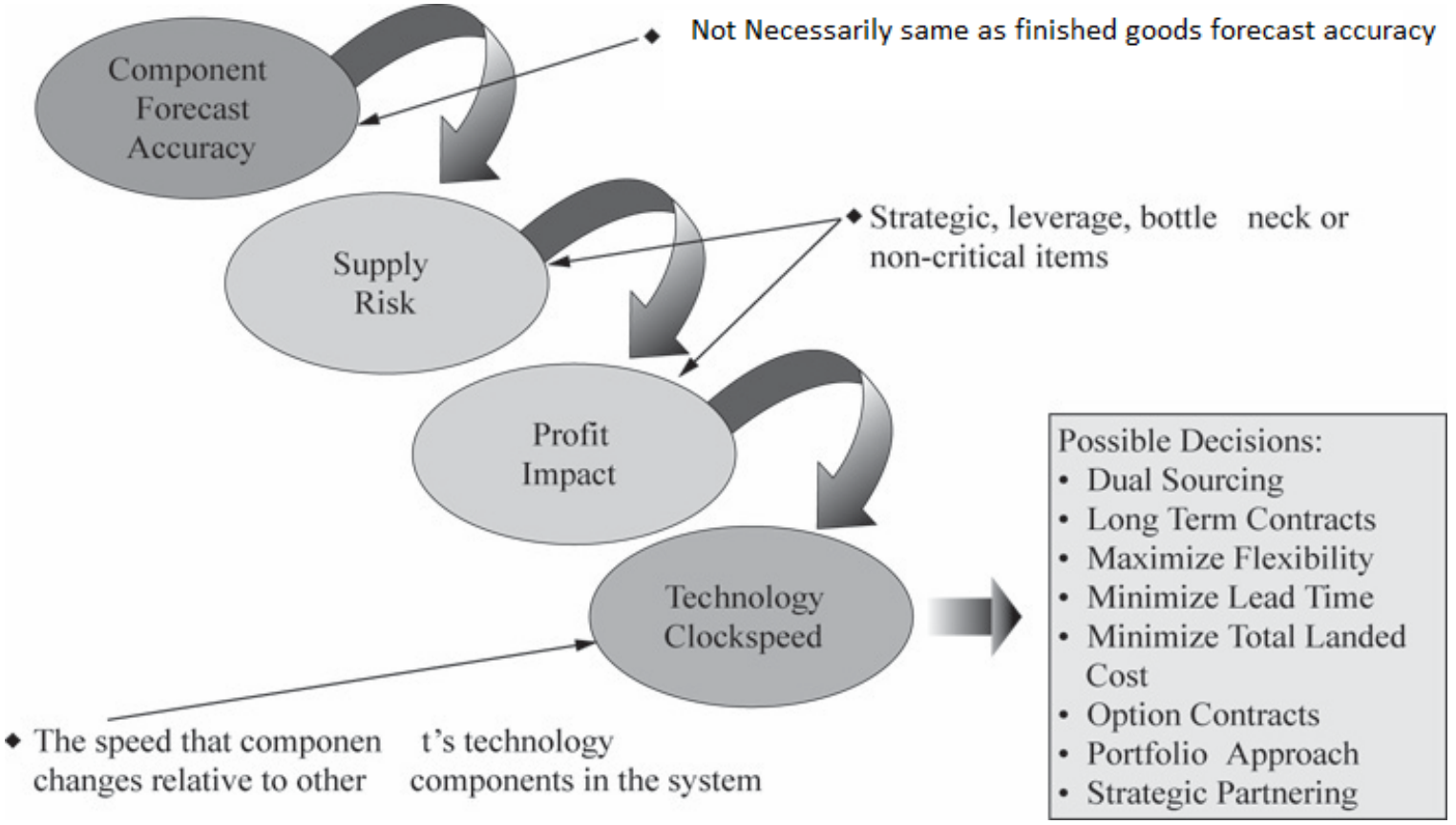

Figure 3: A qualitative approach for evaluating component sourcing strategy

Summary

- Outsourcing has both benefits and risks
- Buy/make decisions should depend on multiple aspects
- Procurement strategies vary from component to component
- Four categories important in selecting suppliers: component forecast accuracy, clockspeed, supply risk, and financial impact