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Supplier Segmentation Strategies Have Never Been More Vital

Understanding what makes a supplier strategic

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Executive Summary

Working closely with strategic suppliers to unearth the most value possible should be a primary objective of every sourcing and procurement organization. But given their limited resources and competing priorities, teams need to focus their efforts where there is the most opportunity. Achieving the right balance between time spent and the potential opportunity requires a well thought out supplier segmentation model – one that not only considers traditional characteristics, such as the amount of spend and business criticality, but also the potential for innovation and overall risk profile.

Effective Supplier Relationship Management Includes a Segmentation Strategy

The Hackett Group defines supplier relationship management (SRM) as "the active management of an organization's key suppliers to maximize value over the full relationship lifecycle." SRM activities should not only link to category management requirements, but to all other supplier-facing processes that must be coordinated and continuously improved. For many, it is the default framework for how the enterprise manages its supply base and uses it to coordinate interactions (sourcing being simply a subprocess) throughout the supplier lifecycle. However, this can quickly become a disadvantage if the scope of SRM implementation activities is not tightly managed.

SRM defines approaches and processes for enterprisewide interactions with suppliers to generate value based on the nature of supplier relationships. This activity may be called supplier management, vendor management or third-party management. Regardless of terminology used, the nature of that relationship – both structural (size, balance of trade, competitive dynamics, etc.) and cultural – affects interactions across the value chain. The goal of SRM is to work with suppliers to reduce costs and respond to changing market conditions, drive innovation and make processes more efficient.

It is essential that SRM teams understand their stakeholders' objectives and whether their current suppliers' capabilities align with these. To prioritize their efforts and determine the right level of engagement with suppliers, SRM teams must create a segmentation strategy. The aim of supplier segmentation is to create a tailored approach for each relationship based on its level of criticality to the business, as determined by a standard set of criteria. Segmentation also helps allocate resources efficiently. To streamline the process, standardized roles, responsibilities and performance metrics must be developed. Procurement's business partners need to be engaged throughout the segmentation process, helping to pressure-test the first draft of the segmentation results.

Reasons for segmenting the supply base

- Provide increased visibility into relationship priorities.
- Establish clear guidelines and characteristics for different suppliers.
- Improve resource allocation across a broad supplier base.
- Motivate suppliers to strive for advancement across supplier tiers.
- Establish common, companywide definitions.
- Identify opportunities to optimize the supplier base.

Some suppliers considered strategic to the company are not specifically aligned to any part of the business. An example is a supplier that provides relocation services to employees, a critical component in employee satisfaction. Travel is another category which can have a major impact on productivity levels, for if travel is not planned and supported efficiently, major productivity problems can result. Sufficient flexibility must be built into the SRM framework to include suppliers like these, which may not check all the boxes as "strategic" but which, based on company goals, deserve high priority.

Companies usually use one of the following approaches to segment the supply base:

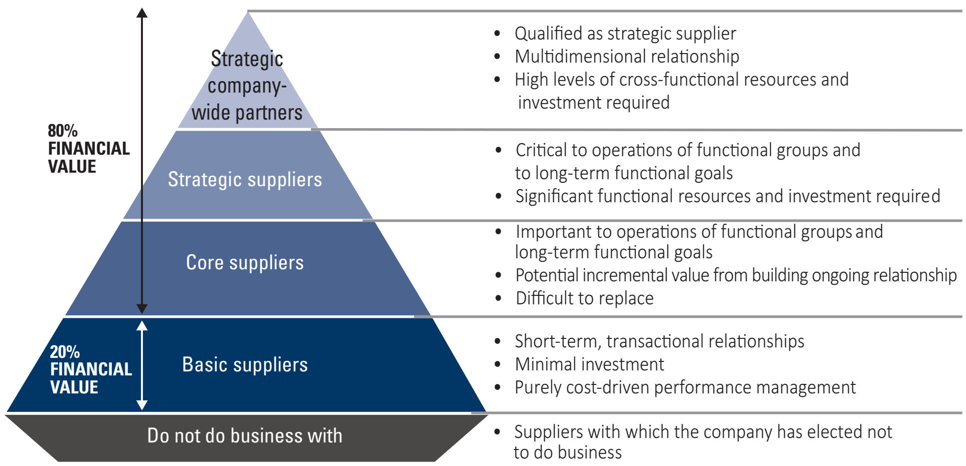
- One-size-fits all: This approach uses multiple stratification criteria and associated evaluative factors to derive an overall importance score to classify suppliers into a single hierarchy. Simplicity is both the main advantage and disadvantage of this approach, as suppliers are not segmented with any substantial level of detail. By way of example, a large manufacturer we know of developed a one-size-fits all system for suppliers of direct materials. Although performance criteria and targets were broad and standardized, becoming a strategic supplier to gain access to long-term agreements required suppliers to exceed a fixed target of purchase-price reductions every year, despite volatile commodity prices. While effective in helping procurement meet its cost-savings targets in the short term, this was not a sustainable practice for a healthy supply base. Further, while the approach created incentives for suppliers to move up in the hierarchy, it also generated a great deal of additional work for the procurement team, which had to respond to suppliers' inquiries about their standing in the hierarchy.
- Complexity vs. impact segmentation: This more popular approach involves some type of two-by-two matrix which plots the business impact of a spend category against supply risk/complexity to create four spending categories: strategic, leverage, bottleneck and routine. The advantage of this approach is that it is highly aligned to category management and sourcing methodologies that attempt to model these same spend categories. It is also used behind the scenes to guide the design and management of service delivery in each of the spend categories. The model can be fine-tuned upstream during the sourcing process and integrated into downstream SRM execution processes, thus tying together not only the KPIs on supplier scorecards, targets, buyer commitments and frequency of measurement, but myriad supplier segmentation criteria. As with the one-size-fits-all approach, this model is simplistic, but it gets organizations thinking about how to tailor SRM to the nature of their spend. Common segmentation groups include:
  - Basic/transactional: Lowest impact and largest supplier grouping within segmentation scope. Minimal resource allocation; ad hoc scorecard reviews. Identifies potential targets for rationalization. Managed at the business-unit level. *Examples:* Landscaping, janitorial services.
  - Core: Commodity-type supplies with large business volume. Spend is readily transferable. Focus is on internal compliance with procurement policies. Annual scorecards used. *Examples:* Office supplies, shipping suppliers.
  - Strategic: High-value suppliers. Resources are invested to grow the relationship. "Customer of choice" initiatives are another area of investment. Semiannual scorecard used. Continuous improvement plans are relatively common. *Examples:* Medical business providers, business consultants.
  - Companywide strategic: The highest-value suppliers. Enterprise/executive-level oversight. Investments in partnership and customer-of-choice initiatives. Semiannual scorecard. Comprehensive continuous improvement plans in place. *Examples:* Print, contingent labor suppliers.

Supplier segmentation best practices

- The 80/20 rule: Segmentation should be done for the suppliers that make up the top 80% of spend (generally about 20% of the supply base), and any additional suppliers that are seen as mission-critical.
- Limited number of supplier tiers: Captures three to five levels of relationships depending on the complexity of interactions with the supply base.
- Qualitative and quantitative inputs: Reflective of both objective, quantitative factors (e.g., spend) and more subjective, qualitative factors (e.g., impact, performance, and integration).
- Cross-functional resource allocation: Takes a cross-functional perspective, integrating input across business units, regions and functions; reflects an enterprise-level view of supplier importance.

Segmentation criteria include the dimensions surrounding supplier/spend type and supplier performance as well as supplier/buyer dependency and willingness to partner (Fig. 1). The latter two are helpful in identifying potential suppliers to collaborate with in early SRM transformation activities to deliver quick wins. As companies become more sophisticated in their supply analytics, they can develop micro-segmentations for detailed supplier interactions to meet all major business requirements. For example, as companies begin to systematize their supplier risk initiatives, they can integrate individualized supplier risk-mitigation plans into ongoing SRM activities.

FIG. 1 Supplier segmentation tiers and characteristics



Source: The Hackett Group

Recommended Approaches to Governance of Strategic Suppliers

A governance framework for each strategic supplier should be created that identifies an escalation path for strategic decisions and issues requiring the involvement of senior leadership. For example:

- Executive sponsor: Provides leadership on the strategy for shaping the direction of relationships with suppliers. The executive sponsor is also responsible for setting SRM team targets and objectives and providing oversight to the program.
- Council: Creates and maintains the governance framework for supplier relationships through policy formation and adherence review. The council helps prioritize SRM initiatives and oversees implementation and execution of strategies. It also serves as the first line for conflict resolution and ensures that anticipated benefits are delivered. The goal is to facilitate regular, open dialogue, establish success criteria, and align the expectations and priorities on both sides of the relationship.
- Business-level operations: Executes the SRM process, making use of established methodology, tools and processes.

SRM teams must dedicate time to ensuring that each level of the relationship has the correct alignment between supplier and company contacts. For example, at the executive sponsor level, the CPO is aligned to the senior vice president (or above) at strategic suppliers. At the council level, more activity-specific work is managed. For example, for discussions about quality, category specialists in the procurement organization work with relationship managers at the supplier. On business continuity topics, project managers are aligned to supplier compliance managers. Category strategists serve on the front lines of the relationship, acting as the primary contact with suppliers to route and escalate issues when they occur.

Measuring Performance

Some performance-evaluation frameworks use two-way dashboards so that both the company and its suppliers have the visibility and accountability they need for a responsive, effective relationship centered on adding value. A typical framework has three main characteristics:

- **Overall relationship dashboard:** Supports a 360-degree feedback approach. Allows the SRM team to assess supplier performance; view KPI metrics to ensure high-quality performance and value-chain visibility; and ensure that an integrated risk management and business continuity plan is in place.
- **A supplier relationship perspective:** Allows suppliers to provide feedback on the SRM team's performance as a customer. Provides visibility into opportunities for improvement and helps drive an end-to-end process transformation agenda designed to accelerate the achievement of strategic objectives.
- **View of opportunities for additional innovations and engagements:** Permits suppliers to identify potential new areas where benefits can be achieved through a systematic approach to identifying, assessing, investing in and collaborating on innovation opportunities.

Working with Strategic Suppliers

Once suppliers are segmented, they must be engaged using appropriate best practices. Developing these capabilities has been a popular focus area, and therefore the level of implementation of best practices is higher compared to other areas. One of these is making a deliberate effort to engage earlier and deeper with suppliers to influence technology/innovation roadmaps or other critical developments.

Effective SRM is characterized by involvement in strategic activities such as joint collaboration with suppliers on cost reductions and revenue/growth enhancement, over and above more tactical activities such as contract monitoring, regulatory compliance and supplier scorecarding (Fig. 2).

FIG. 2 SRM activities by supplier tier

TIERS	ACTIVITIES
STRATEGIC COMPANY-WIDE PARTNERS	• Dedicated cross-functional account team / resources • Formal joint objective and goal planning process • Active joint identification of opportunities to expand relationship across the company • Aggressive pursuit of joint value opportunities • Executive-to-executive relationships • Formal, multilevel governance process • Significant supplier relationship management investment • Experienced supplier relationship managers
STRATEGIC SUPPLIERS	• Dedicated account team with cross-functional participation • Formal joint objective and goal planning process • Active joint identification of opportunities to expand relationship within function • Aggressive pursuit of joint value opportunities within function • Executive-to-executive relationships • Formal, multilevel governance process • Significant supplier relationship management investment • Experienced supplier relationship managers
CORE SUPPLIERS	• Formal account management process • Communication of objective to suppliers • Formal governance process • Limited supplier relationship management investment
BASIC SUPPLIERS	• Governance process consists of ad hoc escalations • Interaction limited to operational and transactional events • Limited plans for future business • Require re-approval annually

Source: The Hackett Group

The value obtained from SRM grows over time as new products and services are jointly conceived to generate revenue growth. Other SRM value drivers include performance management, opportunities for collaboration, and reduction of risk (operational, reputational, financial). As supplier collaboration increases, value can be accelerated. However, without rigorous supplier management, savings negotiated by sourcing can dissipate.

Conclusion and Recommendations

As value chains become more global, virtual and outsourced, SRM can help companies manage suppliers as extensions of their own value chain and in the process, become a customer of choice. Examples include:

- Helping suppliers improve their process capabilities, lower their costs and perform continuous improvement through supplier development activities.
- Agreeing to pilot suppliers' innovations.
- Serving as a reference for suppliers looking to improve their sales.
- Assembling a virtual supply chain of compatible suppliers to create new service offerings.
- Co-licensing technology, forming joint ventures and taking equity stakes in each other's company.

In turn, procurement organizations must take a hard look at how their own company is viewed, segmented and prioritized by suppliers based on the latter's business strategy, and plan accordingly. It may be helpful to embark on formal relationship assessments between senior executives, supplier surveys ("reverse scorecards"), supplier conferences and benchmarking. Supplier satisfaction surveys are a popular technique.

SRM teams must also address the complexity involved in coordinating the input of numerous stakeholders from their own company as well as suppliers. This may require training staff to navigate complex organizational barriers to leverage resources (those of the company and suppliers) and understand the possibilities (and limits) of SRM.

Since supplier segmentation can change over time, it should be reviewed annually. For example, a supplier can be critical to a buying company, but the buying company is not considered a strategic customer to the supplier. In a case like this, SRM teams must concentrate on developing the relationship with the supplier in order to become strategic. This can only happen if the relationship is mutually beneficial. There are also scenarios in which a strategic supplier is reassigned to the "tactical" category – for example, if a product becomes obsolete or is no longer needed, or if the SRM program's strategic objectives change. In another scenario, a supplier may be "key" to one business unit but another may consider it only "preferred." In situations like this, the supplier's overall SRM classification should remain as "key" (the most critical of the different groupings) at an enterprise level. This designation helps SRM teams treat the supplier as a whole in order to gain more leverage in negotiations.

Related Hackett Research

"Supplier Relationship Management, Part 1: Tapping the Power of Top Performance in SRM," December 2011

"Supplier Relationship Management, Part 2: Defining SRM Objectives to Prioritize Capability Improvements," February 2013

"Supplier Relationship Management, Part 3: Building the Business Case for SRM," February 2013

About the Advisors

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Mr. Connaughton leads the development of The Hackett Group's intellectual property in the areas of strategic sourcing and procurement. He has over 15 years of experience in supply chain and procurement research and advisory roles. He has published groundbreaking research in areas like spend analysis, contract life cycle management, supplier risk assessments and services procurement. Prior to joining Hackett, he was principal analyst at Forrester Research, where he focused primarily on helping executives mitigate risk through more effective supplier relationship management. Previously, Mr. Connaughton was a consulting manager at Manhattan Associates and Accenture.

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Mr. Sawchuk has nearly 20 years of experience in supply management, working directly with Fortune 500 and midsized companies around the globe and in a variety of industries to improve all aspects of procurement, including process redesign, technology enablement, operations strategy planning, organizational change and strategic sourcing. Mr. Sawchuk is a regular contributor to business publications, a frequent presenter at industry events and co-author of *ePurchasingPlus*. He has been recognized by *Supply & Demand Chain Executive* magazine as one of its "Pros to Know." Mr. Sawchuk's background includes engineering and operation roles with both United Technologies and IBM.

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