

How retail and consumer companies  
can use strategic sourcing to achieve  
business objectives.\*



# Executive summary

## The role of a sourcing business unit

When senior management recognizes that sourcing can enable its strategic business objectives, an emerging best practice is to establish a dedicated sourcing business unit. Having this business unit in place ensures that its performance and that of its managers and executives (and, by extension, all sourcing activities) are directly linked to the strategic objectives of the enterprise. As such, the business unit can proactively identify both support or core services that can be sourced at the right price, at the right quality and in a manner that is closely aligned to the company's market strategy. Moreover, executives can determine which sourcing models are appropriate for various internal functions and what functions are emerging as candidates for effective sourcing.

Finally, the business unit can be responsible for establishing an effective, standardized and ongoing governance model for all outsourced functions, associated service providers and internal stakeholders. This helps to ensure that sourcing-related decision-making is based on a consistent process and is not done on an ad hoc basis.

Efficiently sourcing back-office functions has long been a focus of retailers and consumer products manufacturers (retail and consumer companies), primarily with an eye on reducing costs. However, given the multitude of challenges facing retail and consumer companies today—such as increasing globalization, growing pressures on margins, and diminishing customer loyalty—these companies have an opportunity to use sourcing much more strategically as an enabler to achieving their key business objectives. Sourcing is not solely about cutting costs, it can be used as a tool to protect and enhance brand equity when thought of on a larger scale.

To use sourcing more strategically, retail and consumer companies may want to use what we will refer to in this paper as a “portfolio approach” to sourcing. A portfolio approach to sourcing allows companies to view and manage all sourcing activities as one portfolio of services a company must provide to support its business model. In doing so, companies develop a holistic view of sourcing activities and needs across businesses and functions that they can use to allocate sourcing resources, develop solutions, and target goals based on what is needed in a given area and what will support the company's overall business objectives. In this context, sourcing refers to the delivery of internal, non-commodity services by the corporation itself or a third-party vendor no matter where the work is actually done geographically. Sourcing solutions include such solutions as outsourcing, offshoring, nearshoring, and shared services (see sidebar).

The purpose of this paper is to discuss the challenges retail and consumer companies face and how strategic sourcing using a portfolio approach can help retail and consumer companies meet such challenges as:

- protecting and enhancing brand value;
- moving into new geographies and markets;
- managing consolidation;
- managing changing markets; and
- dealing with margin pressures.

# New challenges

Numerous trends and changes are buffeting retail and consumer companies. Rapid globalization is now a given as even retail and consumer companies operating primarily in the U.S. market have seen increased competition from non-U.S. global competitors. A slowing economy has put pressure on margins, and the rapid growth of alternative buying channels and widespread access to competitive product information have lessened customer loyalty. Regardless of the pressures faced by retail and consumer companies, investors and the capital market still demand continuous revenue and profit growth in order to drive the creation of incremental shareholder value. To deliver the expected level of financial returns, companies in this sector are seeking new ways to maximize value from their operational base—requiring more flexible, agile and operationally efficient organizational models—and looking for ways to provide the best possible value to end consumers.

In our view, effective sourcing is essential to retail and consumer companies if they hope to exploit opportunities and address today's challenges. Although PricewaterhouseCoopers' research finds that more than two-thirds of retail and consumer companies are using some form of sourcing such as shared services or outsourcing/offshoring, it is less clear whether this sourcing activity is being approached strategically in a way that helps companies deal effectively with the challenges they face and achieve their strategic objectives in the increasingly global environment.

Although cutting costs is often a key driver of sourcing decisions, not all sourcing strategies will, or even should, reduce expenses. Strategic sourcing delivers value in a multitude of ways outside of operational leverage or the standard labor cost arbitrage model. Sourcing can help retail and consumer companies manage cultural issues, gain access to best-of-breed processes and applications, free resources for other strategic initiatives, create a cost-effective foundation for organic growth and acquisitions, and manage the risks of a new venture. Used strategically and with a broad mindset, a portfolio approach to sourcing can help retail and consumer companies deal with issues generally not considered in the context of a sourcing decision.

## A range of sourcing solutions

**Outsourcing.** The provision of clearly defined operations and services that used to be sourced from internal/"owned" resources by an external, third-party entity specializing in the management of that operation.

**Shared services center.** An internal organization charged with converging and streamlining a company's functions to improve their efficiency and effectiveness.

**Offshoring.** Moving business processes from one country to another whether the work is done by a company's own employees or by a third-party vendor.

**Onshoring.** Moving its business processes to a lower cost area within the same country.

**Nearshoring.** Moving business processes offshore to a nearby country, particularly one that shares a border with the country where the company's main operations are located. For example, U.S. companies might nearshore processes to Canada or Mexico.

# The portfolio approach to sourcing

**Joint ventures.** Used to gain entrance into foreign markets whereby the company seeking market penetration contributes new technologies, manufacturing expertise, capital, etc., in exchange for sourcing local market knowledge, an understanding of regulatory/legal compliance issues, local customs/tastes, politics and sales assistance.

**Captives.** Captive organizations are typical shared service solutions to specific back office corporate activities that are provided onshore, offshore or nearshore by third parties or by the corporation itself.

By taking a portfolio approach to sourcing—that is, viewing the entire portfolio of services a company must provide to support its business model in terms of how, where and by whom they are delivered, or “sourced”—companies can develop a holistic view of sourcing activities and needs across businesses and functions. Thus, companies using a portfolio approach will develop a sourcing strategy that aligns the sourcing method (shared services vs. distributed; onshore vs. near-shore vs. offshore; captive vs. third-party) with corporate needs and strategy using the optimal way to deliver a specific service or function.

With this broad perspective, retail and consumer companies can allocate sourcing resources, develop sourcing delivery solutions, and address key corporate initiatives based on what is needed in a given area, as well as what will support the company’s overall business objectives. One function or business might benefit by using sourcing to gain access to best-of-breed solutions; for example, to access advanced call queuing algorithms in call centers or software development expertise around specific applications or business issues. Another company might seek to spur growth by using sourcing to tap into local market expertise when introducing a new brand overseas.

In each case, the recognition that there is no universally “correct” approach to delivering a back-office service is the foundation to an effective portfolio approach to sourcing. Aligning a delivery or sourcing model to a specific strategic requirement, allows the company to choose the best sourcing option for a particular function and objective, leverage existing sourcing relationships and models, and manage sourcing relationships more efficiently.

A number of retail and consumer companies are embracing this approach. Beginning when a high level analysis of needs and sourcing options was accomplished, a portfolio approach that acknowledged interdependencies between the various business functions and potential sourcing solutions was developed. Thus, companies not only identified the sourcing approach that provided the

optimal delivery model for a functional area, but they also defined how the specific solution fit into or aligned itself with the whole portfolio of sourcing solutions. For example, a common issue is determining how to coordinate service delivery and governance where both third-party vendors and captive shared service organizations provide key elements of the service. A portfolio approach to sourcing with its concomitant governance structure can provide a clear enterprise-wide context for sourcing decisions, enabling outcomes to be tracked across all sourcing solutions and compared against desired and planned benefits. With this capability, retail and consumer companies can better leverage cost savings, operating flexibility and other efficiencies gained through effective sourcing to determine where to focus their capital and effort for the greatest return.

Proctor & Gamble (P&G) uses a portfolio approach to sourcing to manage an effective IT multi-sourcing arrangement. To gain access to best-of-breed applications, P&G awarded four portions of its outsourced IT operations to three service providers with an understanding that the three providers would interact and cooperate as needed. With one provider's software running on another provider's infrastructure, this interdependence could lead to conflict if something goes wrong. Therefore, P&G carefully manages this portfolio with quarterly meetings with vendors to air concerns and encourage communication among the providers. P&G's IT managers also share effective outsourcing practices with these vendors, set clear standards for performance, and focus on internal customer satisfaction. Since P&G initiated this portfolio approach to governing the multiple contracts, service levels have improved significantly.

As in the P&G example, key to a portfolio approach is a corporation's willingness and ability to manage multiple sourcing solutions in order to gain access to best-of-breed solutions and services. A successful portfolio approach to sourcing allows companies to identify sourcing options/strategies and then to design and implement a portfolio approach that addresses the underlying strategic business drivers, the specific needs of each function within the company, the circumstances surrounding the decision to source each function, and the unique objectives of each sourcing effort. In doing this, it is important to recognize that in many cases there are multiple goals and that one sourcing approach, one third-party, may offer the optimal solution, but rather that a combination will.

Regardless, the key to identifying the optimal portfolio mix of sourcing solutions is to align the solution with the needs. In P&G's case, the sourcing solution was designed to reduce operating and technology costs and access best-of-breed applications while also minimizing the risk of technology-related disruptions.

As P&G demonstrated along with cost reduction and access to expertise, risk management is a key issue as sourcing activities have tremendous impact on a retail and consumer company's risk profile. The political, business, and financial risks of a sourcing solution not meeting its objectives can be considerable and must be carefully managed and mitigated. Therefore, any approach to strategic

sourcing must help retail and consumer companies manage sourcing-related risks, such as reputation risk, the risk of a service disruption or a breach in data security. Developing governance models and capabilities to manage multiple sourcing arrangements across an enterprise and manage the growing complexity of the sourcing decisions themselves is key, not only to capturing financial and operational benefits, but also to managing risk.<sup>1</sup>

A portfolio approach to sourcing provides opportunities for companies to manage the overall risks inherent in sourcing within a standardized enterprise framework. By looking at all sourcing activities as a whole, a company can identify the risk profile of all sourcing activities and, more importantly, how changes and additions to sourcing activities affect that risk profile. This framework allows companies to identify important strategic drivers involving risk or that need protection from undue risk. An overall goal of these risk management activities is to protect retail and consumer companies' most important asset—their brands.

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<sup>1</sup> “The Future of Outsourcing: How it’s transforming whole industries and changing the way we work,” “Special Report—Outsourcing,” **BusinessWeek online** [[www.businessweek.com](http://www.businessweek.com)], January 30, 2006.

# The portfolio approach in practice

There are many specific situations where a portfolio approach to strategic sourcing can help retail and consumer companies to achieve their strategic business goals.

**Protecting and enhancing brand value.** Strategic sourcing can have major implications for retail and consumer companies' brands and brand management initiatives. Up until recently, many retail and consumer companies have made the assumption that, in order to minimize brand risk, an effective sourcing strategy should not allow third-parties to provide services that touch the brand, such as customer-facing functions. However, we have found that many retail and consumer companies are effectively sourcing functions that touch the brand either directly or indirectly, taking the approach that owning a process does not necessarily mean that it is a core competency of the company and that the process may be more effectively delivered by a third party that can provide best-of-breed capabilities.

As a starting point, some retail and consumer companies are outsourcing non-core functions, such as back-office processes, in order to allocate more capital and management attention to brand initiatives. Others are outsourcing enabling functions, such as web presence or other IT services that support the brand, while others are outsourcing and offshoring core brand-sensitive functions, such as product development, local market research and customer call centers, in order to access local market knowledge or deliver a third-party best-in-class solution.

And some companies are finding that a combination of these approaches provides the appropriate mix of control over the brand and access to best-of-breed services. For example, a company may decide that owning the point of contact with a customer, such as a call center, is strategically important and should be handled by the company itself, while deciding to outsource the management of the IT infrastructure and applications that support customer contact.

In another example, a company may use sourcing strategies to help with the initial development of a brand initiative to avoid the upfront human and financial capital commitment, then take the function in-house once deemed a success and critical to the company's strategy. To illustrate, office products and services dealer Allied Office Products, Inc. outsourced the development and maintenance of its web site with the goal of having the web site become a critical customer interface that generates at least 25 percent of all company revenue. Once the company's web site met that goal, and Allied decided the site had become important to its strategy and brand, the decision was made to bring the function in-house. Using this strategy, Allied was able to cost-effectively leverage the expertise of the third party to develop what became a key strategic component of its sales organization, reducing the cost of development and freeing capital for other important initiatives.<sup>2</sup>

In short, companies can use a portfolio approach to sourcing to identify the key elements of a strategic function they need to retain as captive and which elements they can outsource to a third party. However, protecting the brand and enhancing its value requires a constant evaluation of existing sourcing arrangements and new alternatives using a rigorous governance model, clear definition, agreement and measurement of service levels and an active approach to aligning sourcing solutions with evolving corporate goals and service level requirements. If such an evaluation demonstrates that sourcing service levels are not meeting requirements or expectations, or that the function or activity being sourced is at the core of a company's value proposition (e.g., the complete customer experience or the quality of the product), the company can act quickly to change its sourcing approach including insourcing (bringing back in house) those activities or functions to correct the situation. As part of developing and managing their sourcing strategy, companies as diverse as American Express, Dell, Nike, and many others, have either brought back in-house functions that had formerly been outsourced, usually call centers for inbound sales and customer support, or developed greater controls, measurement and governance for these sourcing relationships, particularly those affecting the supply chain.

**Moving into a new market or geography.** While a number of retail and consumer companies already have a global footprint, there are many that are just beginning their global expansion efforts. In our view, a company moving into a new market or expanding into new countries or geographic regions can use strategic sourcing as a way to gain local market knowledge and test the market with greater flexibility until it is more firmly established. The portfolio approach to sourcing can help the company assess what it needs and how it will operate in the new market in order to fit the right sourcing solutions into that overall vision rather than looking at sourcing on a function-by-function basis.

A company that is testing new markets is likely to want to maintain optimum operational flexibility and avoid a fixed-cost base until it has established itself and

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<sup>2</sup> "End of the Affair" by Alan R. Earls, *Computerworld*, May 31, 2004.

its operating model in a new territory. As an example, this company can use the portfolio approach to identify sourcing strategies that leverage local expertise and resources on a variable, short to medium-term basis, such as utilizing local back office support (or leveraging existing offshore capabilities), outsourcing market research functions, and entering into sourcing-related joint ventures or partnerships. This way, the company can understand a new market and develop or adapt an operating model to meet the requirements of that market without creating an entrenched fixed-cost base until, and unless, a successful operating model for that market has been identified.

Success in new brand introductions and global retailing often depends on local market knowledge and experience. As part of their efforts to extend their brands and/or retail presence into new markets, retail and consumer companies can, for example, rely on outsourced local market expertise to identify and hire employees and to provide market research and product development services. While this approach is not without risk, particularly when it comes to intellectual property protection, these risks can be mitigated and need to be balanced against the benefit of avoiding a fixed-cost infrastructure while testing a developing market.

For example, a retailer that was recently launching a new line of stores and had to hire almost 600 employees used a third-party provider to identify, hire, and train employees. This approach turned recruitment into a variable cost and allowed the company to tap into local market expertise. With a recruiting agency managing off-site, high-volume recruitment centers, the retailer increased hiring efficiencies by reducing the average interview-to-hire ratio from 6:1 to 2:1 and met the required deadlines.

Retail and consumer companies that are extending their product and geographic scope can use a portfolio sourcing approach to structure global sourcing models with some combination of captive or third-party providers to handle the company's initial and ongoing back-office operations and support. In many cases, as a company establishes its operating model in a new market, those requirements will vary as the company adapts its operations in order to penetrate the new market and develop product/marketing requirements. In this case, the sourcing strategy provides strategic flexibility versus cost savings by leveraging short-term, variable cost arrangements while a company establishes itself in a new market. Once a "steady state" operating model has been achieved, the company can afford to take on a higher level of fixed costs for greater operational leverage and cost savings for ongoing back-office requirements.

**Consolidation.** The retail and consumer industry is experiencing consolidation and restructuring at a brisk pace. Relying on mergers and acquisitions (M&A) as a key strategic driver of shareholder value dramatically increases the importance of quickly realizing expected post-deal synergies and achieving the desired end state for these transactions.

In our experience, a well-thought out sourcing strategy should be a key component in an acquirer's arsenal for realizing planned-for synergies following a merger or acquisition. Indeed, as part of due diligence, an acquirer should focus on and seek to leverage a target's sourcing programs/solutions if they provide greater efficiencies. For example, following its acquisition of Maytag, Whirlpool took stock of the portfolio of sourcing arrangements within Maytag and leveraged the human resources outsourcing arrangement Maytag had put in place to handle payroll and benefits and pension administration rather than spending an estimated \$10 million to upgrade its own computer systems.<sup>3</sup>

The portfolio approach to sourcing can create tremendous value for retail and consumer companies involved in M&A activities, helping them to analyze, deploy, and manage sourcing when acquiring businesses and to build a network of reliable service providers. For example, a company can expand the scope of the due diligence effort to include a detailed examination of sourcing in order to determine which processes and functions might be candidates for more effective sourcing and the potential cost savings and operational benefits that could be captured. This examination can focus on several key areas, including current sourcing arrangements (internal and external sourcing structures), their effectiveness, existing sourcing-related contractual obligations, amounts being spent on sourcing, the state and structure of current sourcing relationships, existing pricing and governance models for these relationships, and whether incumbent providers can handle additional volume, if necessary, after the transaction closes.

With a clear view of the portfolio of existing sourcing relationships from both companies, the new combined entity can determine if those relationships can and should be leveraged to deliver synergies more quickly and create incremental value. This decision will depend on how well those existing sourcing relationships are working and whether there are ways to gain new value from sourcing analogous functions in the new company. For example, if an acquiring company has already effectively sourced and transformed its accounts payable processes, that relationship and those processes could allow the acquirer to quickly transfer the acquired company's accounts payable process to the sourced provider to more quickly reap the benefits of the associated savings and efficiency.

When two large consumer products companies recently merged, their plan was to leverage sourcing options as a way to maximize the value created by the newly combined entity. To that end, the merged company developed a shared services center to extend its geographic reach, reduce costs, and increase the quality of its services. At the same time, the company evaluated its sourcing portfolio to identify ways to leverage its outsourcing synergies to enhance its research and development (R&D) capabilities, free up its internal resources to focus on its core competencies, and, of course, to save money. The ultimate goal of both of these initiatives was to generate strong operating cash flow to reduce debt and fund established growth initiatives.

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<sup>3</sup> "BPO Bandwagon" by Michelle V. Rafter, *Workforce Management*, November 7, 2005.

**Managing changing markets and consumer preferences.** Rapidly changing customer tastes are leading to shorter product life cycles, lead times, and production cycles, as well as new innovation channels. In our view, retail and consumer companies can be using the portfolio approach to sourcing to identify sourcing opportunities in areas like customer relationship management (CRM), R&D, marketing research, call centers, and IT outsourcing as a way to deal with those demands. For example, some retail and consumer companies are greatly increasing the amount of new product development coming from outsourcing partners. For example, Proctor & Gamble more than doubled its innovation success rate by increasing R&D outsourcing while reducing its R&D investment as a percentage of sales from 4.8 percent to 3.4 percent. In other cases, companies are entering into joint ventures or divesting all or parts of their business to sourcing partners in order to concentrate on core competencies or to gain access to the sourcing partner's greater efficiency, lower costs, or expertise in a given area.

By using sourcing to evaluate available external expertise, retail and consumer companies can gain access to a profusion of ideas unavailable within the walls of a single company. Some retail and consumer companies, including office furniture manufacturer Herman Miller, are turning to a hybrid sourcing solution to gain outside expertise and perspective for what many would consider a core strategic function: product design. By developing a portfolio to sourcing relationships with designers from all over the world, Herman Miller has access to a wide range of approaches for solutions and it can count on these designers to challenge Herman Miller's internal capabilities and force the company into extending its expertise. External designers are not limited by corporate assumptions and the need to compromise their design solution to suit the expectations of those in a corporate hierarchy. Frequently, Herman Miller engineers will look at the design being considered and deem it "impossible" because it is beyond their current expertise. But instead of compromising to fit into Herman Miller's comfort zone, the outside designers push on with their vision to find a solution and, in the process, stretch the capabilities of those inside the company. Indeed, the ability to maintain a culture that welcomes and encourages partnering with external and excellent designers with diverse approaches has become a core competency for Herman Miller.<sup>4</sup>

**Margin compression.** Faced with rising input costs, fierce competition, a deflationary economic environment, and complex supply chains, retail and consumer companies are being challenged with tightening margins. Although this paper has set out compelling examples of why retail and consumer companies should explore a portfolio approach to sourcing strategies that are not driven by achieving a reduction in expenses, retail and consumer companies must address margin pressures as they look for ways to maintain and increase margins to deliver shareholder value. Companies dealing with margin compression tend to focus on cost reductions as their primary goal. A portfolio approach to sourcing can help these companies decide where to set up sourcing arrangements with low cost/

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<sup>4</sup> "Outsourcing design and innovation" by Kenneth Munsch, *Research Technology Management*, January 2004

offshore sourcing solutions, identify where they can reduce costs and increase efficiency—for example, by reducing costs along the supply chain; access best-of-breed solutions; and use fewer people and maintain that low headcount as the company adds markets across the globe. By disaggregating sourcing decisions and arrangements, the portfolio approach allows a company to identify when and where achieving cost savings is the priority, and when other sourcing arrangements are more appropriate because they will increase operating leverage and efficiency provide strategic flexibility, or access to best-of-breed solutions even if they may not reduce costs.

# Other considerations: Determining the need for pre-sourcing transformation

What comes first, outsourcing or process improvements and the introduction of enabling applications? This is a key question retail and consumer companies need to ask themselves when implementing a sourcing strategy. In particular, companies that have undergone multiple acquisitions and have not standardized and harmonized the resulting patchwork of IT platforms and back office processes are often dealing with processes that require multiple ways of doing things and systems that are still operating in silos. For example, some companies have multiple finance and accounting systems that continue to operate in parallel and are only integrated for closing the books.

Whether to improve processes before or after adopting an appropriate sourcing model depends largely on the costs vs. benefits of the effort and whether improvement or transformation is a desired benefit of the sourcing decision. For example, a company whose headquarters is located in western Europe that sources some functions to a low-cost country like Romania can reduce costs from \$43,000 per employee to \$11,000 per employee. Of course, in this case, the company would still be saving money, but the savings realized through sourcing could be exponentially greater when processes and systems are transformed beforehand and reduce the number of workers necessary from, say, 100 to 60.

Many companies also rely on ERP systems to standardize processes and move functions to a shared services center before eventually outsourcing them altogether for even greater savings. If the processes under consideration require significant transformation and are within the expertise of the sourced service provider, it may be more beneficial to structure a partnership clause in the contract with the service provider for process improvements complemented by gain sharing.

# Conclusion

When it comes to developing an effective sourcing strategy, retail and consumer companies can begin by asking themselves certain key questions:

1. What issues should the company address through sourcing?
2. Does the company have a strong understanding of all of its existing sourcing arrangements, their goals, and their overall performance and effectiveness?
3. Does the company have existing sourcing arrangements that can be expanded or modified to accommodate new and emerging needs?
4. Is the company prepared to source functions and activities that directly touch or support its brand?

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