6 Managing Relationships with Suppliers

A STARTING POINT: CHANGES IN SUPPLY

The ways in which companies approach the tasks of purchasing the supplies they need has changed considerably over the past 15 years. Some of these changes have occurred over a very short period, others have been more gradual but no less substantial. At least three major trends have been apparent.

Outsourcing Activities to Suppliers

This has been part of the move for companies to specialise in fewer of the activities that are necessary to meet the requirements of their customers. Companies have tended to concentrate on some kind of "core competence", with the aim of increasing both their effectiveness and efficiency. This trend has been accentuated because of increases in the number of different technologies a company now needs in order to be able to operate in a particular product area and because of the greater cost of developing each subsequent generation of technology. Because of this, companies have become increasingly dependent on the technologies of their suppliers. The outcome is that purchased goods and services now account for a share of total costs that is rarely less than 50 per cent and often more than two-thirds. Some are getting close to becoming a "virtual company" that relies more or less completely on sub-contracting traditional activities such as design, manufacturing, logistics and order handling to others.

Reducing the Number of Suppliers Used

The extent of supply-base reduction varies between industries. Outsourcing has been most evident in the automotive industry, where it started early. Ford in the USA reduced its supplier base from 3,200 to 2,100 in six years. Chrysler decreased the number of suppliers from more than 3,000 to just over 1,000 in a few years, during the first half of the 1990s. Similar changes are also evident in other industries. One of the most drastic reductions was by Rank Xerox which decreased its supplier base from almost 5,000 to little more than 300.

Developing "Partnerships" with Suppliers

The third major change on the supply side involves new attitudes to the relationships between a company and its suppliers and frequently means changes in the roles of those suppliers. Today, collaboration with suppliers in various forms of partnerships is advocated as a prescription to improve effectiveness and efficiency in the internal operations of a company. These partnerships are often assumed to offer a "win–win" situation, in contrast to the adversarial attitudes that used to be typical of many supplier relationships. These earlier attitudes were based on the "arm's length" relations that were recommended as a way to avoid dependence on individual suppliers. Today, the importance of activities such as joint product development and the growth of integrated logistical systems between companies have increased the long-term dependency between buying companies and their suppliers.

Companies have increasingly become aware of the importance of the supply side of their operations and many have reconsidered their approach to supply activities in a number of ways. Many companies appear to have recognised the importance of relationships with their suppliers much earlier than they have with their customers. Acknowledging the importance of supplier relationships has led to a changed approach to the purchasing function or, as it is sometimes called, "supply management". The three trends testify to a growing ambition to manage supplier relationships more effectively and strategically. Despite this, many companies face the problem of trying to encourage a more strategic approach within a function that retains a traditional orientation towards the more clerical and routine aspects of order processing.

The Aim and Scope of this Chapter

The supply side of companies can make a major contribution to company success, but the link between changes in purchasing and performance improvement is often complex. There is a clear impression that many companies have somewhat naively welcomed the changes that are under way as a shift from something old and obsolete to something new and modern. Following the "discovery" of relationships there is a tendency to present "good, close supplier relationships" (whatever that might mean) as the solution for most of a company's problems. We believe that this view is dangerous for management practice as it oversimplifies the complex problems involved in supply management. For this reason, our main aim in this chapter is to try to develop a more balanced view of the issues facing a company in managing its supplier relationships. We are particularly concerned with the role of supplier relationships in the wider operations of a company and how they affect its overall performance. We start the chapter by examining how supplier relationships affect companies, and present a structure for assessing the costs and benefits of supplier relationships. We will then look at what is involved in managing these supplier relationships. Finally we discuss a structure for a company's overall **supply strategy** using three dimensions; the scope of a company's supplies, the structure of its supply base and its posture in its supplier relationships.

ANALYSING SUPPLIER RELATIONSHIPS

There is no such thing as a *typical* supplier relationship and not all of them have the same potential or impact on a company.

Some relationships are important because of their immediate, direct monetary consequences. Others have benefits that will show up only over time. The effects and importance of a particular supplier relationship depend on how it relates to the company's internal operations and on its interdependencies with other supplier and customer relationships. Some of these effects are easy to explore and measure, others are more difficult to identify because they are qualitative and will only become apparent in the future. Some effects arise within the single relationship itself, while others stem from the impact of the relationship on the company's internal operations or its other relationships. It is important to appreciate that the impact on a company of a particular relationship cannot be assessed just from what goes on within the relationship itself. The impact and the value of a supplier relationship can only be determined by the way it is used by the company and in the context of the company's other relationships. This is what makes that value difficult to assess. Irrespective of these difficulties, the analysis of the current and potential contribution of supplier relationships is a prerequisite for the development of a strategic approach to their management.

Supplier relationships affect the costs and revenues of both of the companies involved. Any attempt to intervene in, or change them has *cost* and *benefit* effects, some of which may be difficult to uncover, measure and quantify. For this reason it will be useful to develop a general framework within which to analyse the multiple consequences of supplier relationships under the two headings of "relationship costs" and "relationship benefits", as illustrated in Figure 6.1.

Relationship Costs

Since external purchases usually represent the major part of a company's overall costs, supplier relationships directly affect the costs of the company. Savings from and through supplier relationships can be very important, and supplier relationships have a profound impact on the cost efficiency of the customer company. Supplier relationships involve two types of cost consequences for a buying company. These are the "direct" costs of procurement and the more "indirect" costs of handling the

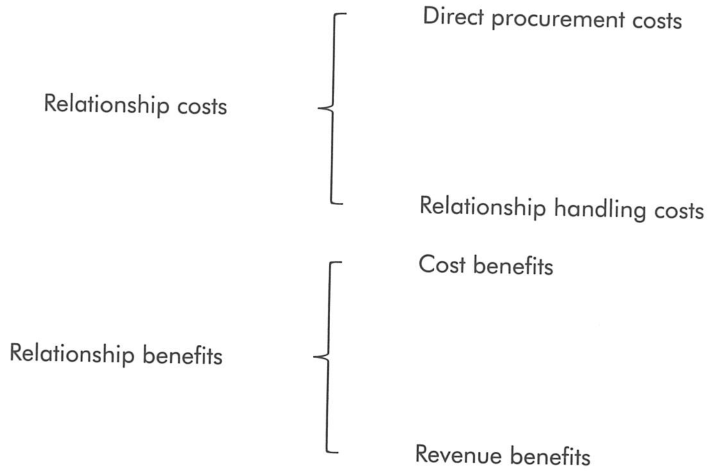

Figure 6.1 *A framework for analysing the economic consequences of supplier relationships*

relationship. The distinction between the two is useful for analysis, even if it is to some extent arbitrary.

Direct Procurement Costs

These consist of cost elements such as the price paid, the logistic costs of transport and handling and some of the administrative costs of processing an order, credits and discounts. Direct procurement costs are the outlays that can be unequivocally attributed to placing an order with a certain supplier. *They are transaction specific.* Traditionally, direct procurement costs have been of major concern to companies and the main focus of their purchasing strategy. Minimising direct procurement costs has been the traditional pre-occupation of the purchasing functions in many companies, even if this has meant that the analysis of other relationship costs and benefits have been neglected.

Relationship Handling Costs

These are of two types. The first are those which can be attributed to a relationship with a specific supplier. These include the costs of adapting the company's internal processes to accommodate that supplier, the costs of supplier training and development, inward inspection and problem solving in the relationship. The second type of relationship handling costs are the structural costs of sustaining the company's purchasing organisation, communication and administrative systems, purchasing research, supplier monitoring and its warehousing operations. These costs can be common for several or all of the company's supplier relationships and are difficult to allocate to a specific supplier. Many of these costs are consequences of investments made in the past such as the capital costs of a warehouse. Relationship handling costs are a function of the activities necessary to develop and maintain supplies. The difficulty of quantifying some of them is not a sufficient reason for disregarding them and many of them can be very considerable. Many relationship handling costs are incurred because of the attempts of both parties to avoid being abused by their counterpart. This means that the development of trust can be an important way of reducing costs in supplier relationships. On the whole, the level of relationship handling costs tends to be a function of the number of *relationships* rather than of the number of *transactions*. These costs tend to rise as the number of suppliers increases, but they also depend on the nature of those supplier relationships. Relationship handling costs reflect the nature of a relationship rather than of the product being purchased, as they originate in the organisational practices and the arrangements that both parties make with each other.

Relationship Benefits

The obvious benefits of supplier relationships are that they are the source of the products, services, components and equipment that a company needs. But more generally, supplier relationships provide access for a company to a major source of both technical and commercial skills that are held by its suppliers. These external resources are a major potential contributor to the development of a company. If properly used, supplier relationships can dramatically enhance the resources and capabilities that a company can make use of and hence improve its overall standing and market effectiveness. In the previous chapter we distinguished between the benefits that can arise *in* a relationship and the longer-term *value of* the relationship itself.

Benefits In *Supplier Relationships*

We can distinguish between two types of benefits that can arise *in* a supplier relationship:

Cost benefits

These are benefits to the company from reductions in costs in other areas of its activities that can be related to a supplier relationship. There are many examples of cost benefits that can be achieved through supplier relationships. For example:

- lower production costs that might be achieved if a supplier modifies a component so that it "fits" more easily into the company's product;
- reduced R & D expenses based on information from a supplier about the use of its product in the customer's application;
- improved material flow brought about by reduced inventories due to changes in delivery frequency and lot sizes;
- reduced administration costs through more integrated information systems.

It is an understatement to suggest that *cost benefits* are hard to measure; they are often even difficult to identify. The reason is that changes in purchasing behaviour and supplier relationships have widespread effects. Take for example the effects of "just in time" deliveries. The changes to delivery frequencies and lot sizes that come from "just in time" have an immediate effect on storage costs and capital turnover. But the *real* benefits of "just in time" deliveries are not simply in materials flow. They have more to do with strategic changes in manufacturing operations, rather than simply from a new approach to purchasing.

Revenue benefits

These are the benefits from a supplier relationship that enhance the revenue generating capacity of the buying company. In the short term, a new supplier relationship can lead to improvements in a customer's product performance or quality and so increase its sales. In the longer term, product innovation and quality improvements can be achieved by making use of a supplier's product development resources or through improvements in its quality of materials, components and production methods. In this way, the customer gains long-term access to the "external" product and process technologies of its suppliers. Quantitative assessment of the revenue benefits of supplier relationships is very difficult, but this fact does not mean that they should not be assessed.

Both types of relationship benefits are similar to relationship handling costs as neither of them show up clearly in book-keeping records, but there are differences:

- Relationship handling costs can often be traced to some total structural cost such as an investment a company makes in information technology or logistics equipment. These costs can sometimes be attributed to a particular supplier relationship.
- Relationship benefits are likely to be both more complicated and diffused and it is often difficult to allocate them to a specific supplier. One reason for this difficulty in quantifying benefits is that the individuals in a company sometimes find it difficult to accept that they have gained from the superior knowledge of a supplier – the well-known "not invented here" syndrome. Some individuals might well be concerned that such an acknowledgement means that some of their activities will be contracted out to such a supplier.

Value of Supplier Relationships

Discussion of the value of a supplier relationship essentially involves an assessment of its future *potential* to provide benefit to the company. The measurement and quantification of this value is difficult for a number of reasons:

- The value of a supplier relationship cannot be judged in abstract. It depends on the *context* of the relationship and not just what happens in it. The costs and benefits of a relationship often affect many areas of the business, such as production, development, logistics or marketing.

- The costs and benefits of a relationship to a company will differ in importance depending on what the company is looking for from that relationship and how it relates to the company's portfolio of other suppliers. For example, if a company doesn't look to a supplier to develop innovative services then it is less likely to value that development if it does occur, or be prepared to incur the costs of it.
- The value of a relationship can't be readily assessed by its current costs and benefits at any one point in time. The costs and benefits of a relationship are cumulative over the life of that relationship. Many relationship costs are incurred in the hope of benefits at some considerable time in the future, such as when a company invests management time in supplier seminars or conferences to achieve greater understanding between the different companies. Similarly, a company may receive short-term benefits from a relationship by taking advantage of a supplier's weakness, but this may mean future costs when the situation is reversed.
- It is difficult to estimate the extent to which individuals in each company learn both technically and commercially through their interactions with supplier personnel.
- We will see in Chapter 9 how the majority of technical developments in business markets originate *between* companies in relationships, rather than within a single company. Despite the importance of innovation between buyer and supplier, it is difficult to assess the effect on the innovation potential of a company of its mutual adaptations of resources and the adjustments in its products, processes and routines.
- Finally, the two participant companies in a relationship are likely to have quite different perceptions of the value of that relationship to themselves and each other. The achievement of that value for each company will depend on the actions of their counterpart as well as themselves.

Despite the difficulties of assessing the value of a relationship, the importance of understanding the different types of short-and long-term costs and benefits of a relationship cannot be overstated. Relationship costs and benefits extend far beyond the obvious ones of immediate price and product and service performance. The development of a strategic approach to a portfolio of suppliers and the management of particular relationships can only make sense on the basis of a real and continuing evaluation of the company's efforts in a relationship and their expected returns.

MANAGING SUPPLIER RELATIONSHIPS AND SUPPLY STRATEGY

Managing supplier relationships is about trying to use them effectively for the purposes the company is pursuing and within the context of a wider relationship portfolio. This is not a simple task!

It is difficult to intervene in supplier relationships because of the complexity of the contact patterns and resources involved and because what happens in them is not the result of unilateral action, but of the interplay between the assessments and actions of *both* companies. Therefore, what we see in most supplier relationships tends to be unique and to be a function of their individual history. There is an unstable variety in supplier relationships, but despite this, companies *need* to intervene and the payoffs from doing this effectively are very worthwhile.

The problems of interdependence and complexity mean that the management of supplier relationships must be based on the reality that a company's purchasing strategy will be the outcome of numerous individual interventions, not always systematic or engineered. It follows also from this that any attempt to apply simple approaches to the task of managing supplier relationships is likely to cause major problems. We can illustrate these problems with two examples.

Reducing purchase costs

Many purchasing texts explain that purchasing is important because bought-in items may account for, say 50 per cent of total costs. If the company has a profit margin of 10 per cent on its sales, then a reduction of 5 per cent in purchasing costs will improve company profitability by 25 per cent. Perhaps! But efforts to achieve a 5 per cent reduction in *direct* purchase cost may cause an increase in the *relationship handling costs* or loss of some *relationship benefits* that more than offset the expected savings. For example, if an automotive assembly company substitutes lower priced and more distant suppliers for its current ones, it may well find that its costs of monitoring those suppliers for quality and delivery are much higher. The costs of increased component failure have an adverse affect on its reputation. The new suppliers may not match those they have replaced for technical development, so that the development load will have to be carried entirely by the customer or the technological level of its products will decline over time. Despite this, many companies approach their supplier relationships with an emphasis on direct purchase cost reduction and this continues to inspire much of the purchasing literature.

Establishing purchasing partnerships

More recently, the purchasing literature and the approach of many companies has swung in an opposite direction towards the idea of developing long-term, co-operative relationships, or "partnerships" with suppliers. Simply expressed, the exhortation is to, "Develop 'good' relationships with suppliers; don't haggle about short-term advantage, co-operate and everything will be fine". As we have seen in previous chapters, the problem is that companies are not faced with choosing *whether or not* to have relationships with each of their suppliers. The issue they face is *what kind* of relationships they should have and how to handle it. Many companies have attempted to establish a "supply-partnership" when no basis for such a relationship exists and it would be much more sensible for them to have distant and impermanent relationships with several suppliers. Other companies have "kept their distance" from some other suppliers when there would have been clear advantages in somewhat closer integration. This means that a more balanced, but inevitably more complex and analytical approach is needed to supplier relationships.

Choice and Change in Supplier Relationships

The need to intervene in a supplier relationship can be induced by changes in either of the two companies or in some of their connected relationships. For any change by supplier or buyer to be implemented, it will have to be accepted by the other company, even if it doesn't like it. The other company might also have to make its own changes to accommodate the shift. This even occurs in the simple case of a supplier's price increase. The customer might accept the increase, rather than switching suppliers, or it might have no alternative. It might then alter its own prices to its customers. If this isn't possible it might try to reduce the prices of other products that it buys or the costs of some of its own internal operations.

Requests and agreements in a supplier relationship are often made by individuals from many different functions such as finance, R & D and production. These might have quite a different view of the company's approach to the relationship from that of purchasing. What we call supply-strategy results from many incremental choices and commitments made by the different people interacting with suppliers. It is not arrived at unilaterally by one company alone and may in practice be rather different from the company's "official" version. Interaction affects both of the companies involved. The outcome of one party's intentions is always mediated by or negotiated with the other and never planned or implemented by one side alone. The process is organic by nature and the closer the relationship, the more dense the interaction and the greater the interdependence.

This interaction inevitably limits the autonomy of a company in its supplier relationships and exposes it to a variety of pressures. Mobilising suppliers, or co-aligning their behaviours, becomes a critical issue in supply strategy. Many of the changes that companies have achieved in the last decade such as removing the need for the inwards-inspection of components have inevitably involved the co-operation of suppliers. This does not mean that attempts to *direct* the development of supplier relationships are absent or should not be considered. The importance of these relationships for a company's performance mean that it *must* strive to control and direct their development. But, it will need to do this in the realisation that change is likely to be slow, complex and the result of interventions by both companies rather than as a straightforward result of a single "master plan" or a few major decisions. The evolution of a company's main supplier relationships will be closely intertwined with developments inside both that supplier and the customer's own operations.

Choice in Supplier Relationships

Supply-strategy can involve a variety of types of relationships and the choice of these must depend on the strategic focus being followed. For example:

- If the company's strategy is aimed at reducing direct procurement costs, this is likely to result in an increase of new, distant relationships, where the emphasis is on delivery of low-priced, standardised product. However, we have already seen that this type of strategy might lead to an increase in its relationship handling costs. This may lead the company to introduce standardised procedures so it can monitor the most difficult of these relationships more closely. We have also seen that a strategy of reducing direct procurement costs is also likely to lead to a loss of relationship benefits. To counter this, the company might increase the emphasis on technical co-operation in some of its existing, long-established relationships.
- If, in contrast, the company's strategy is aimed at achieving cost or revenue benefits then this is likely to involve fewer and closer relationships. If the company is seeking revenue benefits by using its suppliers to assist its new product development then there are likely to be extensive contacts between both company's marketing, research and development staff, as well as negotiations between the two companies' finance functions about how the financial risks are to be shared between the two companies. If the company is seeking the benefit of reducing its production costs, then the production functions of the two companies are much more likely to be involved. In both of these cases, a company's concentration on development in *some* of its relationships might mean that it tries to reduce its relationship

handling costs in others by reducing its commitment to developing them and by simplifying its procedures.