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# Taking supplier collaboration to the next level

Closer relationships between buyers and suppliers could create significant value and help supply chains become more resilient. New research sheds light on the ingredients for success.

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**Companies with advanced procurement functions** know that there are limits to the value they can generate by focusing purely on the price of the products and services they buy. These organizations understand that when buyers and suppliers are willing and able to cooperate, they can often find ways to unlock significant new sources of value that benefit them both.

Buyers and suppliers can work together to develop innovative new products, for example, boosting revenues and profits for both parties. They can take an integrated approach to supply-chain optimization, redesigning their processes together to reduce waste and redundant effort, or jointly purchasing raw materials. Or they can collaborate in forecasting, planning, and capacity management—thereby improving service levels, mitigating risks, and strengthening the combined supply chain.

Earlier work has shown that supplier collaboration really does move the needle for companies that do it well. In one McKinsey survey of more than 100 large organizations in multiple sectors, companies that regularly collaborated with suppliers demonstrated higher growth, lower operating costs, and greater profitability than their industry peers (Exhibit 1).

Despite the value at stake, however, the benefits of supplier collaboration have proved difficult to access. While many companies can point to individual examples of successful collaborations with suppliers, executives often tell us that they have struggled to integrate the approach into their overall procurement and supply-chain strategies.

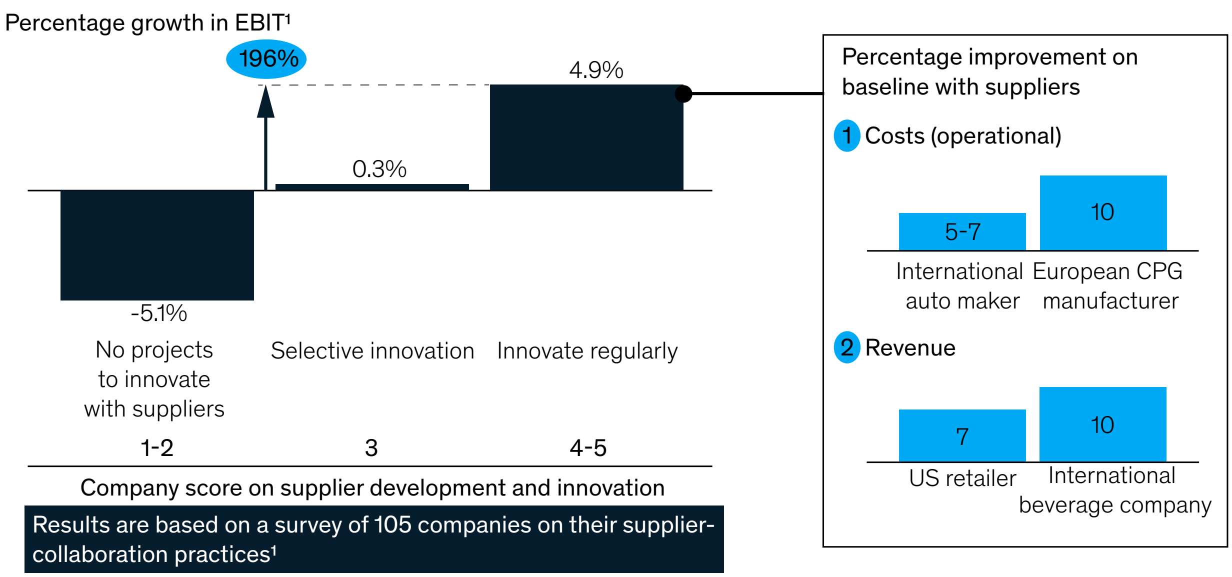
## Barriers to collaboration

Several factors make supplier collaboration challenging. Projects may require significant time and management effort before they generate value, leading companies to prioritize

Exhibit 1

**Companies with advanced supplier-collaboration capabilities tend to outperform their peers.**

**Leaders in supplier development and innovation tend to beat industry trends by ~2x in growth and other metrics**




[1]Earnings before interest and taxes; high-growth companies also showed strong starting EBIT (i.e. growth was not due to weak starting positions)
Source:McKinsey Procurement Practice

simpler, faster initiatives, even if they are worth less. Collaboration requires a change in mind-sets among buyers and suppliers, who may be used to more transactional or even adversarial relationships. And most collaborative efforts need intensive, cross-functional involvement from both sides, a marked change to the normal working methods at many companies. This change from a cost-based to a value-based way of thinking requires a paradigm shift in many firms that is often difficult to come by.

The actual value generated by collaborating can also be difficult to quantify, especially when companies are also pursuing more conventional procurement and supply-chain improvement strategies with the same suppliers, or when they are simultaneously updating product designs and production processes. And even when companies have the will to pursue greater levels of supplier collaboration, leaders often admit that they don't have the skill, lacking the structures they need to design great supplier-collaboration programs, and being short of staff with the capabilities to run them. After all, what great supplier collaboration necessitates is much more than the mere application of a process or framework—it requires the buy-in and long-term commitment of leaders and decision makers.

## A shared perspective

To understand more about the factors that hamper or enable supplier-collaboration programs, we partnered with Michigan State University (MSU) to develop a new way of looking at companies' use of supplier collaboration. The Supplier Collaboration Index (SCI) is a survey- and interview-based benchmarking tool that assesses supplier-collaboration programs over five major dimensions (Exhibit 2).

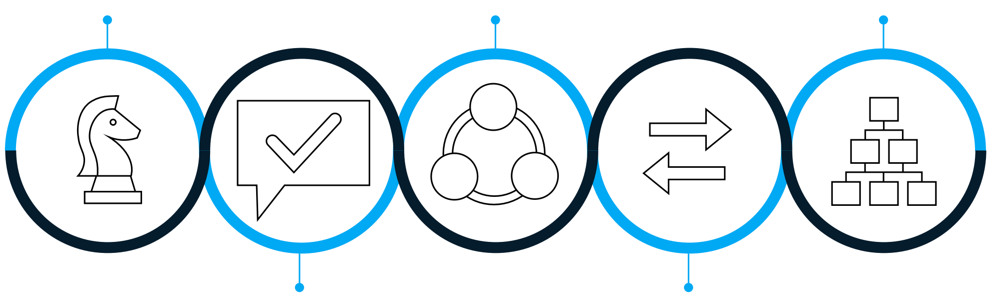
Exhibit 2

**The Supplier Collaboration Index assesses the five major dimensions that underpin successful collaboration programs.**

Strategic alignment
- Company's overall strategic goals and objectives
- Classification as strategic
- Scope of collaboration initiatives

Cross-functional engagement
- Breadth of relationship across organization
- Quality and outcomes of engagement across functions
- Ability to navigate across respective organizations

Organizational governance
- Incentive structure for sustainable collaboration
- Type and frequency for mutual feedback
- Agreed-upon metrics to measure performance and track progress



Communication and trust
- Mutual trust
- Type and timeliness of information
- Tools and supporting mechanisms

Value creation and sharing
- Fair value sharing between supplier and manufacturer
- Adequate room for healthy financial health
- Rewards for positive performance on collaboration initiatives

Source: McKinsey/MSU Supplier Collaboration Index Team

During 2019, researchers from McKinsey and MSU rolled out the Index in a pilot project involving a dozen leading consumer-goods companies in North America, along with ten to 15 of each company's strategic suppliers. We collected more than 300 written responses from more than 130 organizations, and conducted in-depth interviews with around 60 buyer and supplier executives. The work provides some important insights on the state of supplier collaboration today, revealing the elements of collaboration that companies and suppliers believe are working well, and the areas that present the greatest challenges.

The results of our consumer-industry benchmark are summarized in Exhibit 3, with average buyer and supplier perceptions of their own collaboration programs rated from one (low) to ten (high) in each of the five dimensions.

Overall, the research reveals close alignment between buyers and suppliers on the relative strength of most dimensions. It also shows a clear drop in perceptions of strength as the discussion moves from theory (strategic alignment) to execution (value creation and sharing, organizational governance).

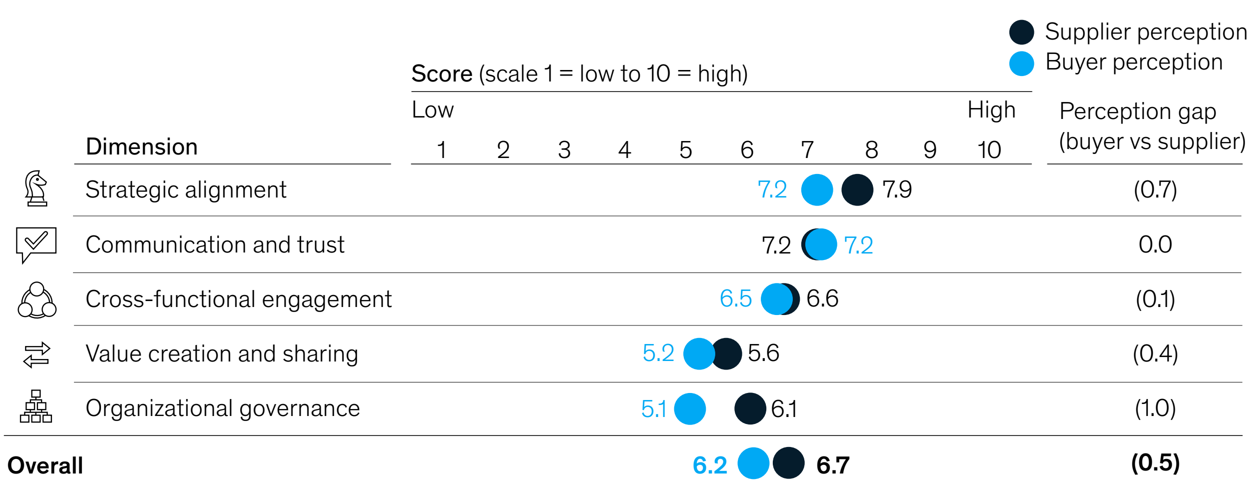
The in-depth interviews conducted with senior buyer and supplier personnel as part of the SCI data-collection process provide further insights into the challenges companies face in each of the five dimensions, while also revealing some examples of best practices that lower-performing companies can emulate.

**Achieving strategic alignment**

Benchmark participants understood who their strategic suppliers are, although they do not all use formal segmentation approaches to categorize their supply bases. Likewise, suppliers understood their strategic importance to their customers. Buyers and suppliers agreed that there was good alignment on the pursuit of sources of value beyond cost—but also agreed that their efforts to capture these value sources were not always successful.

Exhibit 3

**Buyer and supplier perceptions were surprisingly close—but scores weakened between alignment and execution.**




Source: McKinsey/MSU Supplier Collaboration Index Team

The first step for an organization is to define what it wants to achieve from its collaboration efforts, and what it needs to do to realize those goals. Internal alignment and commitment by senior managers to ensure appropriate resources are available is also critical. For example, in a quest to develop more sustainable detergents, Unilever partnered with Novozyme—a major supplier of enzymes—to jointly develop new enzyme solutions. The collaboration leveraged each party's strengths, merging Unilever's understanding of which types of stains and materials were most relevant with Novozyme's reagent-optimization capabilities. The partnership resulted in two enzyme innovations that improved product performance, increased market penetration, and allowed the company to target premium-branded competitors. Moreover, the new formulation performed well at lower temperatures, helping customers save energy and reduce CO2 emissions.

Other organizations participating in SCI have introduced formal methods to promote greater strategic alignment, such as through a joint business-planning approach. The buyer and supplier align on short- and long-term business objectives, set out mutual targets, and jointly develop plans to achieve objectives. Areas of opportunity for collaboration include growth, innovation, productivity, quality, and margins (see sidebar, "Joint business planning").

**Communication and trust**

Buyers and sellers both describe high levels of trust in relationships that they consider strategic. In most cases, that trust has been built up over time, based on longstanding business relationships. Companies involved in collaborations tend to appreciate each other's capabilities, understand each other's businesses, and believe that their partners will stick to the commitments they make.

Companies are less convinced, however, that their partners will be ready to put the interests of the collaboration above the interests of their own organization. Many interview participants noted that greater transparency over sensitive areas such as costs was key to attaining the highest level of collaboration, but said that this goal was often difficult to achieve.

Building trust takes time and effort. Often this means starting small, with simple collaboration efforts that deliver results quickly, building momentum. This way, companies can demonstrate a serious approach to collaboration and their willingness to share gains fairly. More importantly, companies should base their relationships on transparency and information sharing as a foundation, with the expectation that greater trust will follow.

Cosmetics company L'Oréal follows this approach to encourage collaborative innovation. Through open dialogs concerning company goals and long-term commitment, L'Oréal has been able to establish an effective codevelopment process. The company's annual "Cherry Pack" exhibition, for example, offers suppliers a preview of the consumer trends that the company will be working on, and asks them to develop packaging solutions in harmony with these trends. During the exhibition, L'Oréal creates a trust-based forum for suppliers to present the ideas and products in development—including ideas that have yet to be patented. The forum thus gives suppliers access to practical short- and long-term ideas and projects that ultimately accelerate packaging innovation.

**Cross-functional engagement**

To generate value from changes in manufacturing methods, quality-assurance regimes, or supply-chain processes, representatives from the respective functions on both sides of the partnership will need to work together. Yet this type of cross-functional engagement is something most benchmark participants find extremely difficult. Executives reported that while traditional relationships—such as those between buyers and supplier sales teams, or suppliers and buyer R&D functions—were strong, wider cross-functional engagement was patchy and poorly managed at best.

## Joint business planning

**Joint business planning** is a collaborative planning process in which the company and its supplier align on short- and long-term business objectives, agree on mutual targets, and jointly develop plans to achieve set objectives (exhibit). It brings a formal approach to collaboration with suppliers and helps to engage stakeholders from different functions in the collaboration effort.

Joint business planning works best when companies have a clear understanding of the strategic suppliers with which they want to engage, and where they have strong core supplier management capabilities in place. The approach can be applied at several levels. At its simplest, joint planning can involve aligning on metrics and value sharing agreements. At its most advanced it can include joint investment to create new sources of value.

Exhibit

**Joint business planning fosters alignment on performance metrics, targets, and key strategies for the year.**

**Develop joint business plans to include:**

- Description of main strategic actions to achieve growth
- Pricing by product
- Performance metrics, such as
  - Volume, growth and margin targets by product, and channel
  - Distribution coverage and growth

**Single spreadsheet workbook per account**

| | | |
|---|---|---|
| Distributor strategy developed during yearly joint planning meeting<br>Date of last update: January 2019 | [Distributor name] and BuyCo | |
| Distributor strategy | *Description of overall vision, objectives, and strategy for distributor* | |
| Main planned initiative to achieve strategy | *Tactical steps and specific large initiatives aimed at achieving distributor strategy* | |
| Opportunities | *Sources of value from collaboration between distributor and BuyCo* | |
| Interaction cadence | *Alignment on cadence for touch points (eg, quarterly performance reviews, annual strategy setting)* | |
| Distributor economics | | |
| | Cost per case ($) | Margin (%) |
| BuyCo | | |
| Distributor | | |
| Customer | | |
| | | |
| Performance incentives | | |
| | Incentive type | Description |
| Incentive 1 | eg, economic | eg, bonus of x% based on achievement of absolute sales target and growth rate of x% |
| Incentive 2 | eg, economic | eg, x% rebate for customer days payable reduction of x% |
| Incentive 3 | eg, non-monetary | eg, sales and installation training for operating staff |

Source: McKinsey Procurement Practice

Improving cross-functional engagement is a leadership issue. Organizations with the most successful collaboration programs use a formal approach to manage cross-functional teams, with clearly defined roles and responsibilities on both sides of the partnership, backed by changes to internal incentive systems to promote full participation in collaboration projects.

Some companies, such as P&G, have taken a step further in creating cross-functional teams solely focused on joint innovation with suppliers. By creating a practice of "open innovation," P&G aimed to coordinate its efforts and leverage the skills and interests of people throughout the company to assess the competitive landscape, identify types of innovation that can help develop disruptive ideas, and identify appropriate external partners. For innovation to work, P&G has stressed the need to integrate cross-functional teams that, in turn, integrate business strategy with operations—which requires a broad network of interactions.

**Value creation and sharing**

The pursuit of shared value is the reason buyers and suppliers take part in collaboration projects, so unsurprisingly procurement executives consider it the most important dimension of their collaboration efforts. Yet few participants in our study track the impact of collaboration on sources of value beyond cost reductions. Where companies have tracked the impact of collaboration projects on revenues, margins, or other metrics, they have done so only for a handful of high-profile projects.

For buyers, additional volume remains the most common way that the extra value created by collaboration projects is shared. Some partnerships had made use of other types of value sharing, such as performance-based incentives for suppliers. Where these approaches were employed, both buyers and suppliers were happy with the results. That suggests significant opportunity for companies to expand their use of such approaches, provided they can reach agreement on cost baselines and incentive structures.

Cost transparency is a critical enabler here. Some companies have found cleansheet cost modeling to be a very effective way to conduct fact-based discussions on costs and improvement opportunities with their collaboration partners (see sidebar, "Cleansheet cost modeling").

ASML, a lithography-equipment manufacturer for the semiconductor industry, operates a value-sharing mechanism for its suppliers. The company allows suppliers to maintain healthy margins (as a volatility buffer), provides financing for the infrastructure needed to make its products, and offers staggered purchase guarantees. In this way, ASML incentivizes and rewards its strategic suppliers for prioritizing its business, gains access to cutting-edge technology, and reduces costs and improves stability in an industry with short lifecycles affected by substantial swings in demand.

Throughout its long history of collaboration with suppliers, P&G has used a wide range of commercial models to partner with suppliers across the entire R&D chain. Its value-sharing models range from shared fund pools for codevelopment of products to licensing agreements for commercialization. The flexibility to employ different mechanisms has allowed P&G to tap into supplier innovation without the need to overinvest in the development of deep partnerships with every potential collaborator.

**Organization and governance**

Like cross-functional engagement, the organization and governance of supplier-collaboration programs suffers from a lack of formal structures and processes. Interviewees admitted that their companies, both buyers and suppliers, were relatively lax in tracking and valuing their supplier-collaboration efforts. Few organizations had done anything to align the incentives of project participants within their own organizations, and most relied on informal mechanisms to share feedback or review progress with partners.

## Cleansheet cost modeling

**Many of the potential sources of value** targeted by supplier-collaboration efforts depend upon a mutual understanding of the true costs of a product or service. Achieving that sort of transparency can, however, be difficult in buyer-supplier relationships. Suppliers may be reluctant to reveal too much about their own manufacturing processes and costs, fearing that this information will be used against them in negotiations, and buyers may not want to let suppliers know just how critical they are.

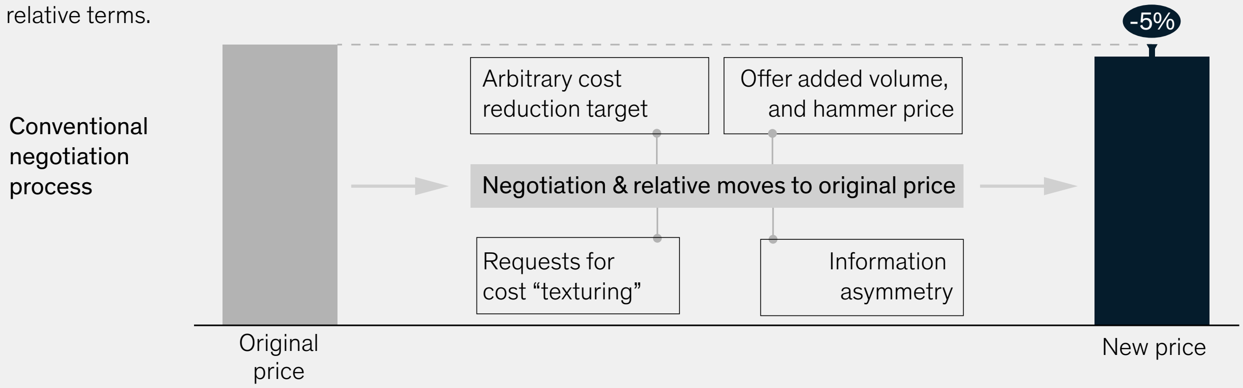
Cleansheet cost-modeling approaches have risen to prominence in recent years as a tool to allow an open, fact-based cost discussion between buyers and suppliers. A cleansheet calculates the cost of each step during the creation of a product, component, or service, using a database of information on the materials, labor, factory space, equipment, time, and energy required to complete each step—and the implications for the desired product volumes on the utilization of those resources.

Cleansheet cost transparency helps collaboration partners generate ideas for design and process improvements. The approach can also underpin value-sharing agreements, allowing organizations to establish clear cost baselines and measure improvements against them.

Exhibit

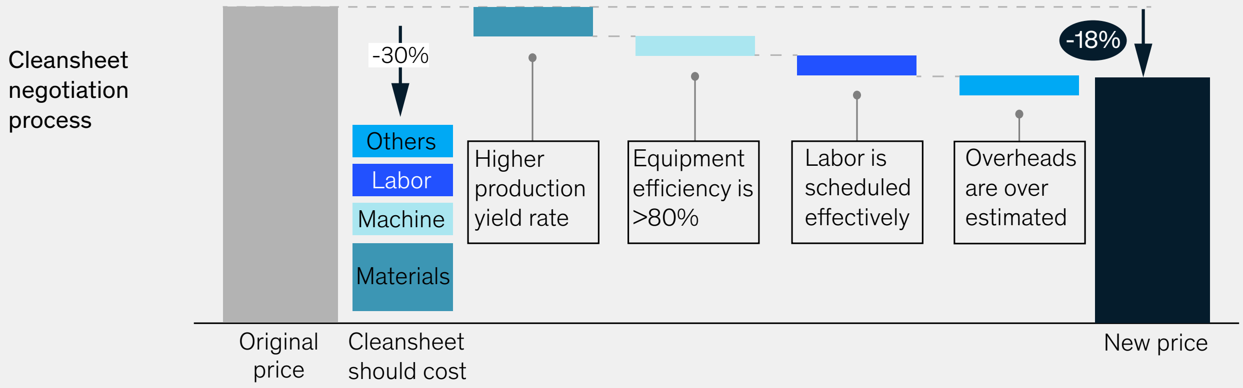
### Conventional negotiations are based on a relative price movement, while cleansheet negotiations can focus on fact-based, collaborative cost and profit.

**Conventional negotiation** starts with an arbitrary point of price and relies on force of will to move it down in relative terms.




**Cleansheet negotiation** starts with the resources needed to make a product and builds to a "should cost," resulting in a far greater cost-reduction opportunity.

**Cleansheet negotiations** establish cost transparency and maximize cost reduction.




Source: McKinsey Procurement Practice

Introducing a clearer governance structure for the overall supplier-collaboration program and for individual projects has the potential to significantly improve outcomes in most organizations. Two-way scorecards, for example, allow buyers and suppliers to let each other know if they are effectively supporting the goals of the program. Governance of collaboration projects should be cross-functional, with appropriate incentives introduced throughout the organization to encourage full participation and ensure both parties pursue long-term win-win opportunities, not just short-term savings.

Several leading organizations have created supplier advisory boards to provide high-level support and guidance for their supplier-management and supplier-collaboration programs. These boards act as a forum for the supplier base to advise on key issues and collaborate with the organization to further its business agenda. Companies use their supplier advisory boards to help manage risks and disruptive threats to the supplier ecosystem, and such boards also serve as a neutral space for the exchange of ideas between the host company and a group of strategic suppliers (see sidebar, "Supplier advisory boards").

Toyota has been a prominent example of supplier collaboration, whose success can be explained in part by the use of clearly defined targets and supplier-performance metrics. These are built into contracts that hold suppliers accountable for continued improvements in quality, cost, and delivery performance. The company governs supplier relationships using a steering committee, staffed with relevant senior stakeholders from both organizations, to define the scope and objectives of the collaboration, review progress, and take action to remove roadblocks and resolve issues as they arise.

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The Supplier Collaboration Index has already revealed several major opportunities for companies seeking to expand and improve their supplier-collaboration efforts. Some of those opportunities are quite straightforward, such as more proactive management of cross-functional teams involved in collaboration projects, or the introduction of formal governance systems to manage those projects. Others, such as greater cost transparency between buyers and suppliers, or the use of performance-based supplier-incentive mechanisms, may require more time and effort to achieve.

Excelling at supplier collaboration requires a more active and engaged working relationship with suppliers. It also calls for a change in mind-set, encouraging both buyers and suppliers to commit to the long-term pursuit of value from their collaborative relationships. We end with eight steps that any organization can take to put its collaboration efforts on the right track.

1. Start by identifying those suppliers that offer unique joint opportunities to create and retain significant value.

2. Align strategically with these partners to define joint objectives and develop a compelling business case for both parties.

3. Adopt a methodical and structured approach to define the scope, pace and targets for joint projects, including a clear methodology on how to measure value creation.

4. Define simple, clear value-sharing mechanisms, and align incentives of the cross-functional team accordingly.

5. Invest in allocating the appropriate resources and building the required infrastructure to support the program.

## Supplier advisory boards

**A supplier advisory board** (or council) serves as a neutral and collaborative forum for the exchange of ideas between the host company and a group of strategic suppliers. Such boards are widely used by companies with mature procurement organizations, and they do so for a variety of reasons. A board may advise on key industry trends, risks, and potentially disruptive threats in the supplier ecosystem. Or they may provide a place for companies to explore the potential impact of business decisions on sourcing strategy. Some boards act as a hub for projects to improve operational processes between the company and its suppliers. Others are assembled to support special projects, such as joint innovation programs or sustainability initiatives.

An advisory board is usually chaired by an executive business sponsor and sourcing lead. Buyer-side members include representatives of multiple functions, such as marketing, legal, and R&D. On the supplier side, companies usually nominate a lead strategic supplier, along with around a dozen supplier board members chosen from the strategic supplier base. Those suppliers are selected after evaluation against a matrix of criteria determined by the objectives of the board.

Exhibit

### Several types of advisory board members can aid in improving supplier collaboration.

| **Advantages** | |
|---|---|
| Business executives (particularly retired executives) | - Expertise in managing larger organizations<br>- Deep knowledge in specific industry<br>- Large network of contacts |
| High-performing entrepreneurs | - Expertise in dealing with issues unique to entrepreneurs<br>- Proven record of prevailing over those issues<br>- Network of contacts useful for other entrepreneurs |
| Consultants | - Framework for assessing organizations that can be applied to all industries<br>- Experience in providing clear, high-impact advice<br>- Resources of larger consulting firm |
| Financial experts | - Can deal with the main issue that many companies often face<br>- Experience in creative financing options<br>- Large network of contacts |
| Business professors | - Deep experience with successful case studies<br>- Framework for assessing organizations that can be applied to all industries<br>- Useful connections to university resources and students who can assist with advisory board's preparatory work and possible internships with companies |

Source: Advisory board lit search; McKinsey analysis

6. Create a governance model focused on performance, implementation tracking, and hardwiring supplier collaboration into core operational processes.

7. Foster a culture founded in proactive communication, transparency, consistency, and knowledge sharing, to strengthen long-term partnerships.

8. Invest in building world-class organizational capabilities to ensure sustainability over time

For any organization seeking to improve the performance of its procurement practices, supplier collaboration can no longer be considered a nice-to-have. As companies reach the limits of conventional purchasing practices, further progress will require a new approach based on close relationships, cross-functional engagement, and the shared pursuit of new value.

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