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Cost Is a Choice

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Chapter One: Cost Is a Choice

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CHAPTER 1

Cost Is a Choice

> *"...the cost of a thing is the amount of what I will call life which is required to be exchanged for it, immediately or in the long run."*
>
> — *Henry David Thoreau,* Walden (*1854*)

On Day 6 I asked Bramwell's leadership team a question I expected to take five minutes. What does this company spend, and with whom?

Celia Marchbanks, the chief financial officer, said accounts payable had paid out $118.6 million in the last twelve months. Arlen Dupree, the purchasing manager, twenty-six years at Bramwell, said purchasing had placed $65.0 million on purchase orders and the rest wasn't his. Nate Ellison, Celia's financial analyst, had the P&L (profit and loss statement) open on his laptop, showing $80.6 million of materials — freight on another line, everything else spread through the expenses below. Three numbers, each one right on its own terms. Not one came with a name.

Arlen could have named every supplier Bramwell used, most of them by first name. What nobody in the room could tell me was which twenty took most of the money, what we paid them part by part, or when anyone had last asked whether we should. That was nobody's fault. Nobody had ever been asked to know it.

Here is the rule I took out of that room. Every dollar you spend with another company was decided by somebody — which part, built to which drawing, in what quantity, from which supplier, on which terms, and managed how after the order. Most of those decisions are old ones, made by default by people long gone, and they repeat themselves every month on purchase orders nobody rereads. Treat every dollar of spend as a choice, and make the few big ones on purpose. Skip that and the choices still get made. Your suppliers' price lists make them.

Cost is a choice. The only open question is who's making it.

The Cheapest Dollar in the Business

Do the arithmetic out loud, because it settles most arguments before they start.

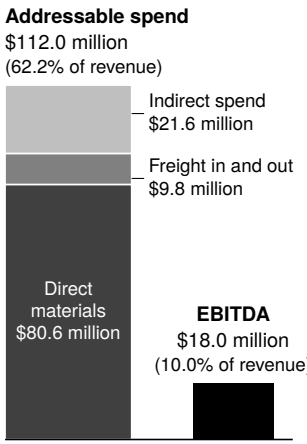
Bramwell bought $112.0 million a year from other companies — materials, freight and the services that kept two plants running — on $180.0 million of revenue and $18.0 million of EBITDA (earnings before interest, taxes, depreciation and amortization). One percent of that spend is $1.12 million. Save it and it drops straight to EBITDA, because nothing else has to change to earn it: no new customer, no new shift, no new inventory. Add $1.12 million to $18.0 million and EBITDA rises 6.2 percent. Pennant Hill Partners, Bramwell's private-equity owner, had paid nine times EBITDA for the company, so that one point of spend is worth $10.08 million of value.

Now compare it with selling more. Bramwell earned 10 cents of EBITDA on the average sales dollar, so the quick answer is $11.2 million of new sales. That answer flatters the savings. A new sales dollar does not carry another share of the rent and the salaries, so it earns more than the average. Contribution is the honest comparison: what a new dollar of sales keeps after materials, freight, direct labor and commissions. At Bramwell that was about 33 cents. Divide $1.12 million by 33 cents on the dollar and you need about $3.4 million of new sales to match 1 percent of spend. That's still three to one. And the sales dollar arrives with a customer to win, capacity to find and a receivable to fund. Count it either way and a dollar saved on spend is still the cheapest dollar in the business.

Only price is faster. Of the five margin levers in *The 80/20 Company*, price comes first because an increase reaches EBITDA the month it lands, and *Get Paid* is the book on that. Purchasing comes second, and in my experience it is the lever most companies have left alone the longest.

Bramwell wasn't unusual. The Census Bureau's survey of manufacturers for 2024 found that U.S. manufacturers spent $3.8 trillion on materials, parts, fuel, electricity and contract work — 55 percent of the $7.0 trillion of goods they shipped. In fabricated metal products the share was 46 percent, in machinery 50 percent and in electrical equipment 47 percent. Bramwell's materials and freight alone came to 50.2 percent of revenue. If you make things, about half of every sales dollar leaves for other companies. Who decides how that half gets spent? In my experience, nobody in particular.

The prize on one page, Bramwell at Day 24



If we save…

Share of spend	Saving a year	EBITDA up	Value at 9 times
1%	$1.12 million	6.2%	$10.08 million
3%	$3.36 million	18.7%	$30.24 million
5%	$5.60 million	31.1%	$50.40 million

Fig. 01-01: The prize on one page: Bramwell's $112.0 million of spend against its $18.0 million of EBITDA, and what 1, 3 and 5 percent of that spend are worth.

Buying Versus Sourcing

Most companies buy. Fewer source. What separates the two is not effort (Arlen's people worked as hard as anyone in the building) but what the effort is aimed at.

Buying gets the company what it needs from outside. Someone names a need, and a buyer picks a supplier, agrees a price and gets the goods in on time, at the lowest cost that meets the quality and the rules. Sourcing steps back from the order. It uses the data — what you spend, what the market charges, what the suppliers can do — to decide what to buy, from whom and on what terms, for years rather than for the next delivery.

	Buying	**Sourcing**
What it is	Getting what you need from outside	Deciding, with data, what to buy and from whom
What it watches	This order, this price	Value over the life of the supply
When it moves	When the need arrives	Before the need arrives
Suppliers	One transaction at a time	Partners, over years

	Buying	Sourcing
What decides	Cost and the rules	Spend, the market and value

Which one is right? Both, for different purchases. Most of what you buy should stay plain buying: the office supplies, the one-time repair, the hundreds of suppliers you pay a few times a year. Put a sourcing project on a supplier you pay $5,000 a year and the meetings will cost more than the saving. Sourcing belongs on the vital few, the handful of suppliers and categories that hold most of the money, and Chapter 3 shows how to find them. Where you lose real money is the other way round: buying the vital few the way you buy the tail.

Four Ways Purchasing Pays

Purchasing pays in four ways. I put profit and cash first, because they're the two your owner can count at the end of the month.

1. Cost: lower prices, lower total cost and better terms. Profit comes from the price and from everything the price leaves out — the freight, the expedites, the scrap found at receiving, the stock you carry. Cash comes from the terms and the stock: when you pay, and whose inventory sits on your floor.
2. Risk: a purchasing team that knows where its supply comes from sees trouble early. It has a plan before the trouble arrives — a second source qualified, stock where it counts, a contract that says who gets served first in a shortage. Nobody notices it until the day it is tested, and that day it is the only one of the four anyone remembers.
3. Value: good suppliers make your product better. They find cost in your drawings, catch defects before they ship and bring ideas your engineers haven't had — but only to customers they trust.
4. Efficiency: fewer suppliers, fewer invoices, fewer expedites, fewer people chasing paper. Bramwell paid 41,600 invoices and placed 18,200 purchase orders a year, and every one of them took somebody's time.

Profit and cash come first, and risk, value and efficiency are how you keep them.

The Ten Steps in Four Phases

Credit for the method belongs elsewhere. It's the one the Institute's course teaches, four phases and ten steps, and it rests on decades of practice by people who buy for a living. Here it is on one page, and the book's four parts follow its four phases.

Phase one is Assessment: see what you buy, and who else could supply it.

1. Diagnostic assessment: what you spend, how your suppliers perform and what their markets are doing.
2. Supplier research and profiles, for today's suppliers and the alternatives, before anyone is asked for a price.
3. Presentation to the category teams, who see the profiles and agree the selection criteria.

Phase two is Profile Analysis to Negotiation Preparation: know before you ask.

4. Profile analysis: what each part should cost, what it costs delivered and what the bids say, line by line.
5. Site visits and due diligence, with everything negotiable on the list.
6. Negotiation preparation: the goals, your alternative to a deal and what each supplier needs, in writing.

Phase three, Negotiations and Supplier Selection, is where the preparation gets spent.

7. Negotiations, run in rounds, with every offer and every trade written down.
8. Supplier selection and the award, with the saving validated by finance before anyone celebrates.

Phase four, Execution and Management, is where the savings land or don't.

9. Transition to the new supplier or the new terms.
10. Long-term alliance management, with the savings ledger, the scorecards and the quarterly reviews.

Risk has no step of its own. It belongs in all ten, and Chapter 11 shows how.

Why not start at step 1 and run all ten in order? Because ten steps done properly take most of a year — longer than any owner should wait for the first dollar. What I add is the order of attack. The 80/20 cut comes first: rank the spend and find the few suppliers and categories that hold most of it before anyone opens a sourcing project. Wave 1 comes next.

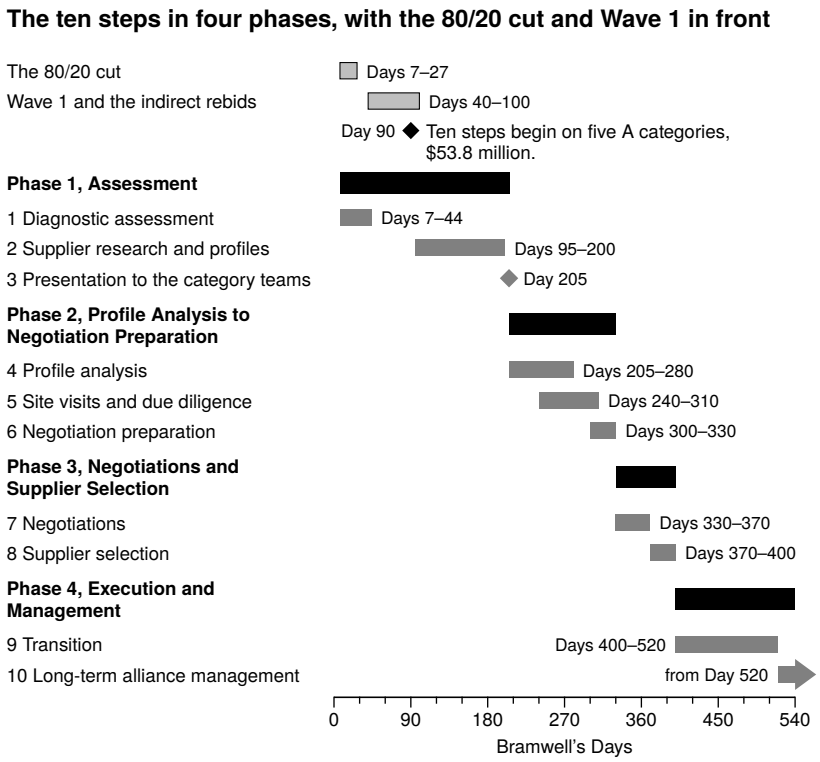


Fig. 01-02: The ten steps in four phases, with the 80/20 cut and Wave 1 run first, and Bramwell's Days for each.

In the first hundred days, reopen the top suppliers whose prices nobody has reviewed in eighteen months, fix the payment terms and start the second sources. Rebid the indirect spend in the same hundred days. It's what you buy to run the company, not to make the product, so it pays quickly, and one good supplier of it is usually as good as the next. That's the fast money, signed while the ten steps are still being chartered. Then the ten steps run on the A categories, the few that carry the most money, each with its own team, over about a year. Wave 2, in Year 2, takes the next tier, the consolidation and the terms. *The 80/20 Company* named the waves. This book runs them.

Tough and Fair

Before you reopen a single price, tell your suppliers in writing what kind of customer you intend to be, keep it short and sign it yourself. Here is a passage I'd copy:

"Over the next year we will look again at everything we buy, including what we buy from you. While that happens, you have four promises from us. We will review every price, tell you the truth about our volumes, pay on the day we promise, and never show your price to anyone else. In return, send us your best price and your best ideas."

Why promise anything? Because squeezing works exactly once. An across-the-board demand, an invented competing quote, a threat to move a part you can't actually move — each one gets you a number. In my experience a supplier squeezed without a reason takes it back where you aren't looking: a slower answer, a looser inspection, a later truck, a lower place on its list the next time capacity runs short. You win the round and lose the supplier.

So be tough on the number and fair to the people. Tough means knowing what a part should cost and expecting to pay that, no more. Fair means no lies and no surprises, no supplier's price used to mislead another, every bill paid on the promised day, and every losing bidder told why. If you've been paying late, the third promise costs real money. Make it anyway. Suppliers decide whether you get their best thinking long before anyone sits down to negotiate (that's Chapter 9).

Before You Start

Answer five tests with your leadership team before you launch, each with a yes or a no. A no does not cancel the program. It goes on the charter as the first thing to fix, with an owner and a date.

1. Alignment: can you say in one sentence which of the company's goals the program serves — margin, cash, a sale in three years — and has your board agreed?
2. Collaboration: will engineering, quality, operations, logistics, finance and sales each name a person to the category teams, and give that person the hours?
3. Market conditions: for each of your biggest categories, do you know whether the market is tightening or loosening (prices, capacity, lead times) before you reopen a price?

4. The people with a say: have you told everyone whose work will change (the plants, engineering, sales, your board and your suppliers) what's coming, why, and what's in it for them?
5. Risk: do you know which purchased items can stop your line, and is there a written plan for each before you start changing suppliers?

Bramwell

I arrived on Day 0 at Bramwell Range Company, which Walter Bramwell had founded in Fort Smith, Arkansas, in 1958. It made commercial ranges, fryers, griddles, charbroilers and convection ovens for about 140 dealers and buying groups and three national restaurant chains. A second plant, in Saltillo, Coahuila, built the convection ovens and the wire harnesses. There were 640 people, $180.0 million of revenue and $18.0 million of EBITDA. Nine months before I came, Pennant Hill had paid $162.0 million for the company, nine times EBITDA. Leland Burroughs chaired the board for Pennant Hill, and Edie Bramwell, the founder's granddaughter, kept a minority stake and a director's seat.

Day 6 was the question nobody could answer. On Day 7 Celia put Nate Ellison on the spend file, and Arlen sat with him most afternoons, saying which names in the system were the same supplier. The file tied to the ledger on Day 21 (Chapter 2 tells how).

On Day 24 the prize went onto one page (Figure 01-01): $112.0 million of spend, 62.2 percent of revenue and more than six times Bramwell's EBITDA. Under it sat three lines. The last said 5 percent was worth $5.60 million a year, 31.1 percent more EBITDA and $50.40 million of value at the multiple Pennant Hill had paid. That afternoon Nate taped his supplier ranking to the conference-room wall, and twelve of the top twenty had not seen a price review in eighteen months or more (Chapter 3 has the rest).

I sent the page to Leland that evening with no target on it. A target set before anyone has priced a single category is a guess with a signature under it. He would get a number, I told him, when the category plans could carry one. He didn't love the answer, but he accepted it.

Day 30 was the letter. Celia, Arlen and I wrote it in an afternoon, and it went to every supplier on the file over my signature and Arlen's. Paying on the day was the expensive promise. Bramwell had been paying a week late, and Celia had worked out what paying on time would cost in cash before a single copy went out. We sent it anyway.

Mack Garrity called Arlen the morning his copy arrived. Garrity Steel & Supply had sold Bramwell steel for forty-one years, and Mack wanted to know whether the first promise meant him too. Arlen told him it meant everyone. Mack said it was the straightest letter he'd had from a customer in years, and that he would have his numbers ready.

That same week the charter went out, one page, signed by Celia and me, naming the scope (all $112.0 million, the A categories first) and the owners: Arlen for Wave 1 and the indirect rebids, and a category manager not yet hired for the ten steps. Celia added one rule of her own: no saving counted until finance had signed it. The charter also answered the five readiness tests, yes or no. Risk was a plain no. Nine items came from a single source, $19.6 million of spend, and not one of them had a written plan.

Wave 1's first list leaned on the overdue reviews. Steel led it, because the processing and delivery adder (the service centers' charge on top of the metal) had drifted to 19 percent of price on all $24.6 million. Then came Tremont Motor & Fan, thirty-eight months without a review, and the nine job shops that made Bramwell's fabricated and machined parts. Packaging and crating would be rebid, and so would the top outbound freight lanes. Beside Wave 1, Arlen's buyers would rebid the indirect spend, starting with the temporary-labor agency, whose price nobody had ever reviewed. Wave 1 started on Day 40, and the ten steps kicked off on Day 90. By Day 100 Celia had signed $2.59 million a year of Wave 1, 2.3 percent of spend, and $1.12 million of indirect rebids beside it. Bramwell was paying every supplier on the day it had promised.

From the Record

Purchasing's own trade body dates to 1915, when it was founded as the National Association of Purchasing Agents. The last word of that name is worth reading slowly. An agent acts on someone else's behalf: somebody else decides what is needed, and the agent goes and gets it.

In 1931 the association set up a panel of its members to report on business, and it has published a monthly report on manufacturing ever since. Once a month, in other words, it asked the people who placed the orders how business looked, and printed what they said.

In 1968 it changed its name to the National Association of Purchasing Management. That's a different word, because a manager is expected to decide and to answer for what the decision costs. An agent answers for the errand. A manager answers for the result. Fourteen years later, in

1982, the association developed the Purchasing Managers' Index with the United States Department of Commerce. By then the agents had become managers, and they had an index to prove it.

By 2001 the association had 48,000 members, and in April of that year they voted to change the name again. On January 1, 2002, it became the Institute for Supply Management. Its chief executive, Paul Novak, said at the time, "We must shed the image that 'purchasing equals transactions.' "

Supply is a bigger word than either of the others. It runs past the purchase order to the supplier's plant and the supplier's own suppliers, to the truck, the dock and the morning something breaks. An agent can place an order. It takes someone who sees the whole supply to decide whether the order should have been placed at all, with whom, and on what terms.

Three names in eighty-seven years, each one a step further from the transaction and a step closer to the choice behind it.

Do This

1. Ask your leadership team the Day 6 question — what do we spend, and with whom — and write every answer on one sheet with its source beside it.
2. Put the prize on one page: spend in three groups against EBITDA, and what 1, 3 and 5 percent of spend are worth at your multiple.
3. Have your chief financial officer work out what a new sales dollar contributes. Add one line to the prize: the new sales it takes to match 1 percent of spend.
4. Score the five readiness tests yes or no with your leadership team, and write every no onto the charter with an owner and a date.
5. Draft the letter with the four promises. Do not sign it until your chief financial officer confirms you can pay every supplier on the day you promise.
6. Name the two people who will build the spend file next week, one from finance and one who knows the suppliers. Give them twelve months of payables, purchase orders and ledger accounts.