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Cost Is a Choice

Field Guide preview

Chapter One: Cost Is a Choice

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Chapter 1

Cost Is a Choice

Chapter 1 of the book. What a saved point of spend is worth, the rules the program runs by, and the five tests to pass before any supplier hears from you. Instruments: worksheets 1, 2 and 3.

In my experience, the purchasing programs that stall are launched with a speech and no page. The chief executive tells the leadership team that suppliers are the next place to find margin, everyone nods, and by the third month purchasing, finance and the plants are arguing over a target none of them can trace to a number. These three worksheets are the page that should have come before the speech.

The first puts a price on one point of spend, in EBITDA and in what the owner's multiple makes of it, so the argument over whether the program is worth running ends before it starts. The second writes down who owns the work, who signs a saving before it counts, and what you've promised the companies that supply you. The third asks five questions your leadership team would rather answer later, and makes it answer them now.

Skip them and you pay three ways. A target shows up before anyone has priced a category, and the first miss takes the program's credibility with it. Two people count the same saving two different ways, and the board stops believing either of them. And a supplier finds the weak spot you never tested for, usually in the week your one source for some part floods, burns or changes hands.

WHAT IT LOOKS LIKE WHEN IT IS MISSING

- Five leaders, asked what the company spends with suppliers, give five answers tens of millions apart, each pulled from a different system.
- Purchasing knows every supplier by first name, and no one can name the twenty who take most of the money.
- The savings target is a round percentage that arrived from above before anyone had priced a category.
- The last cost drive was a letter asking every supplier for the same cut, and the best of them answered with slower quotes and later trucks.
- Payables runs past terms at month-end to make the cash number, and every supplier's credit manager has noticed.
- Purchasing is judged on price per order, the plants on output and engineering on launch dates, and nobody on what the company buys in total.
- Ask which bought parts could stop a line next month, and you get a shrug or a list nobody has written down.

The tell is a company that can state its revenue to the decimal and can't say, without a week of digging, who gets the half of it that goes out to other companies.

IN THE BOOK

Chapter 1 argues that what you pay suppliers is a pile of old decisions (the part, the drawing, the quantity, the supplier, the terms and how the supplier is managed afterward), most of them made by default and repeated every month since, and that the few big ones deserve to be made deliberately. It does the arithmetic first. A point of spend saved goes straight to EBITDA, so it beats almost any dollar of new sales, and only a price increase reaches the bottom line faster. Then it separates buying from sourcing, names the four ways purchasing pays (cost, risk, value and efficiency), lays out the course's four phases and ten steps, with the 80/20 cut, then Wave 1, put in front of them, and sets the tone in a short letter: hard on price, straight with people. Its instruments: a one-page prize, a charter that travels with a letter to every supplier, and five readiness questions, each answered yes or no before launch. The rule is to treat every dollar of spend as somebody's decision and to make the big decisions on purpose. At Bramwell the prize reached the chair on Day 24 with no target on it, the letter reached every supplier on Day 30, and Wave 1 was worth $2.59 million a year before the ten steps were ten days old. Its Do This list, as a checklist:

Put the Day 6 question to your leadership team, what we spend and with whom, and record every answer on one sheet next to the place it came from.

Draw the prize on one page: the three groups of spend beside EBITDA, and what saving 1, 3 or 5 percent of it would be worth at your owner's multiple.

Get finance's figure for the contribution on a new sales dollar, and add a line for the new sales it would take to equal 1 percent of spend.

Have the leadership team answer the five readiness tests, each one yes or no, and carry every no to the charter with a name and a date beside it.

Draft the letter with its four promises, and hold your signature until finance has confirmed that every supplier can be paid on the day promised.

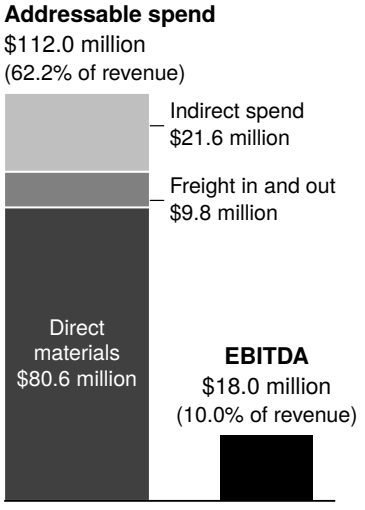
Pick the pair who will start the spend file next week, someone from finance and someone who knows every supplier by name, and hand them a year of payables, orders and ledger accounts.

WORKED EXAMPLE

I put the question to the leadership team on Day 6: what does Bramwell spend, and with whom? Celia Marchbanks answered $118.6 million, what accounts payable had paid over twelve months. Arlen Dupree answered $65.0 million, what his buyers had placed on purchase orders. Nate Ellison read $80.6 million of materials off the P&L. Each was right about something different, and not one answer came with a supplier's name attached. Celia gave Nate the spend file the next morning, it tied to the ledger on Day 21, and on Day 24 the prize went onto its page. Direct materials took $80.6 million, freight $9.8 million, the indirect categories $21.6 million, so $112.0 million went to other companies, 62.2 percent of revenue ($180.0 million) and a little over six times the $18.0 million of EBITDA.

One percent of that is $1.12 million, and since a saving needs no new customer, shift or stock to earn it, all of it lands in EBITDA: $1.12 million ÷ $18.0 million is 6.2 percent more. Pennant Hill had paid nine times EBITDA, so the same point is worth $1.12 million × 9 = $10.08 million of value. Three points: $3.36 million a year, EBITDA up 18.7 percent, $30.24 million of value. Five points: $5.60 million, up 31.1 percent, $50.40 million. The page carried one more line, for whoever asked why we didn't just sell more. At the average margin of 10 cents, $1.12 million of EBITDA takes $11.2 million of new sales. A new dollar keeps more than an average one, though, because it brings no extra rent or salaries with it. At Bramwell it kept about 33 cents once materials, freight, direct labor and commissions were paid, and $1.12 million ÷ 0.33 is about $3.4 million. Three dollars of selling to match one of buying, and the selling comes with a customer to win. That evening the page went to Leland Burroughs, the chair, with no target on it. The number would come when the category plans could hold one.

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.

Celia, Arlen and I wrote the letter in one afternoon, and on Day 30 it went to every supplier in the file over Arlen's signature and mine. The costly promise was the third. We had been paying seven days late, and Celia had priced paying on time before a copy left the building. The bill arrived on Day 100: paying everyone outside fourteen large suppliers on time used $0.96 million of cash, while moving those fourteen to net 52 released $2.38 million. Mack Garrity phoned Arlen as soon as his copy landed, wanting to know if the first promise covered forty-one years of Garrity steel. Arlen said it covered everybody. That week Celia and I also signed the charter, one page: all $112.0 million in scope, the A categories first, Wave 1 owned by Arlen, the ten steps owned by a category manager we hadn't hired yet, and Celia's rule that nothing counts as saved until finance signs it.

The charter carried the five readiness answers, and risk was the plain no. Nine bought items had one source each, $19.6 million of spend between them, and none had a written plan. Wave 1 began on Day 40 with steel at the top of its list, the service centers' processing and delivery adder having crept to 19 percent of price across all $24.6 million. The ten steps began on Day 90 on the five A categories, $53.8 million. Celia signed Wave 1 at $2.59 million a year on Day 100, 2.3 percent of spend, and the indirect rebids at $1.12 million. From that day every supplier was paid when promised.

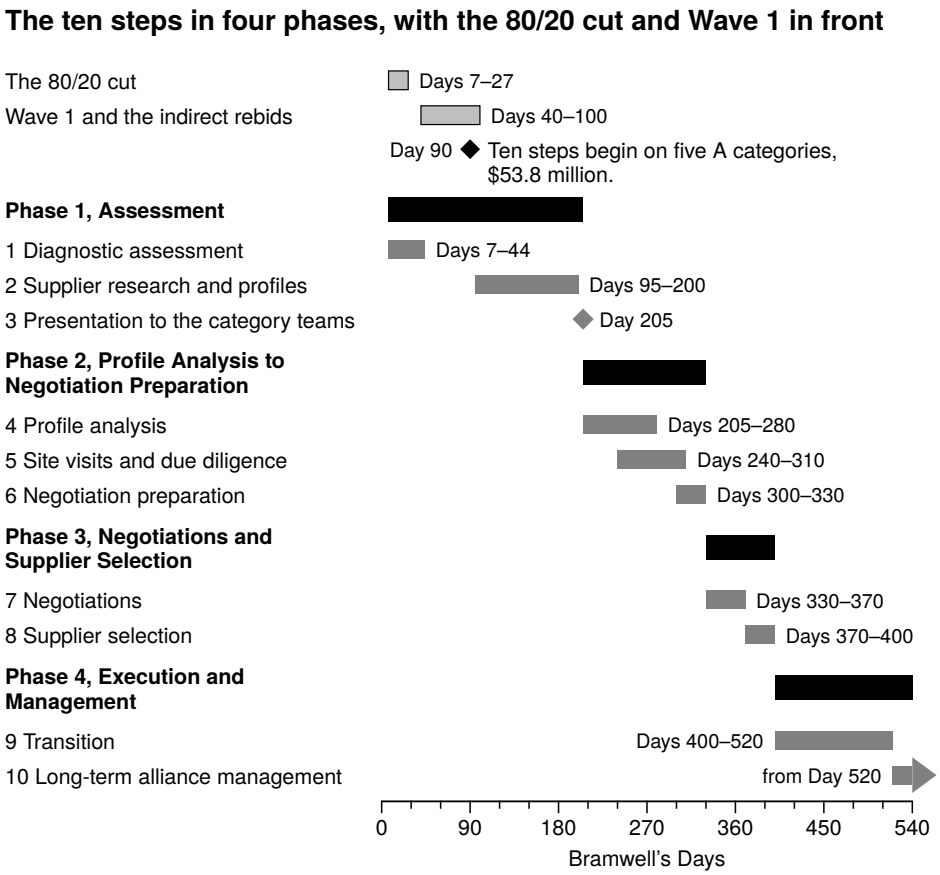


Fig. 01-02: The ten steps in four phases, with the 80/20 cut and Wave 1 run first, and Bramwell's Days for each.

WORKSHEETS

The chapter's work fits on three pages: what a point of spend is worth, the rules and the promises, and the five tests.

WORKSHEET 1

The prize — spend, margin and value on one page

What one point of spend is worth in EBITDA and in value, beside what it takes to earn the same dollar by selling more. Finance and the analyst fill it in, and the chief executive takes it to the board.

Start with the Day 6 question. Ask it around the table and write down what comes back.

Every answer, who gave it and where it came from

The page. Draft it from the ledger now, and redo it the day the spend file ties. By hand or with the tools you have. Tie the totals to the ledger.

Revenue, last twelve months

EBITDA, and its share of revenue

Direct materials

Freight, in and out

Indirect spend

Addressable spend, and its share of revenue

The multiple your owner paid

Points of spend	Saved a year	EBITDA rises	Value at the multiple

Against selling more. Use finance's contribution figure, not the average margin.

What a new sales dollar contributes

Sales needed to equal 1 percent of spend

No target anywhere on the page

Bramwell's version

On Day 6 the question drew three numbers and no names: $118.6 million from Celia Marchbanks (accounts payable), $65.0 million from Arlen Dupree (purchase orders) and $80.6 million from Nate Ellison (materials on the P&L). The page went to Leland Burroughs on Day 24 without a target: $80.6 million + $9.8 million + $21.6 million = $112.0 million, which is 62.2 percent of revenue, set against $18.0 million of EBITDA and the nine times Pennant Hill paid. A new sales dollar kept about 33 cents, so matching 1 percent of spend took $1.12 million ÷ 0.33, about $3.4 million of new sales.

Points of spend	Saved a year	EBITDA rises	Value at nine times
1 percent	$1.12 million	6.2 percent	$10.08 million
3 percent	$3.36 million	18.7 percent	$30.24 million
5 percent	$5.60 million	31.1 percent	$50.40 million

WORKSHEET 2

The program charter and the letter to suppliers

One page of rules for the program, and a short letter telling every supplier what kind of customer you mean to be. The chief executive writes both with finance and purchasing, and signs both.

The charter. One page. If it needs two, something on it hasn't been decided.

What the program serves, in one sentence

Scope in dollars, and what goes first

Owners: Wave 1, the indirect rebids, and the ten steps

Who signs a saving before it counts

Wave 1's first list, and why each name is on it

Each no from Worksheet 3: owner and date

Signed by, and the date

The letter. A paragraph in plain words, over your own name. The four promises, every one of them meant:

Every price reviewed, theirs included
The truth about our volumes
Every invoice paid on the day we promised
Their price kept private, from everyone

Cash it takes to pay on the day (finance)

Finance confirms we can: name and date

Sent on, to how many, over whose names

Bramwell's version
Celia Marchbanks and I signed the charter the week of Day 30. The letter, written that same week by Celia, Arlen Dupree and me, went to every supplier in the file on Day 30 over Arlen's signature and mine.

Line	Bramwell's charter
Scope	Every dollar of the $112.0 million, A categories first
Owners	Arlen, Wave 1 and the indirect rebids. A category manager not yet hired, the ten steps (Simone Langford, from Day 45)
Counting	Nothing counts as saved until finance signs it (Celia's rule)
Wave 1's first list	Steel, its adder at 19 percent of price on $24.6 million. Tremont, 38 months unreviewed. The nine job shops. Packaging and crating. The top outbound freight lanes. Beside them, the indirect spend to rebid, the temporary-labor agency first
Readiness	Risk a plain no: nine single-source items, $19.6 million, no written plan
The third promise	Seven days late on average until Day 100. Paying everyone outside fourteen large suppliers on time then used $0.96 million of cash

WORKSHEET 3

The five readiness tests

Five questions for the leadership team before launch, each answered yes or no, and every no carried onto the charter as work with a name on it. The chief executive asks, and the leadership team answers in one sitting.

Yes or no, nothing in between. A no doesn't stop the program. It becomes the first thing to fix.

1. Alignment: one-sentence goal, board agreed
2. Collaboration: a named person per function
3. Market: tightening or loosening, by category
4. The people with a say: all told, and why
5. Risk: what can stop the line, a plan for each

Every no, with its fix.

Test	The fix	Owner	Date

Items that can stop the line, and their spend

Every no written onto the charter, owned and dated

Bramwell's version
The leadership team scored the five the week of Day 30, and the answers went onto the charter. Four came back yes. Risk came back a plain no, and its fix went onto the charter ahead of everything else. Inside Wave 1, Simone Langford's team drew the single-source map, and second sources were started on three of the nine items: Danforth Combustion for the gas valve, Sierra Castings in Monterrey for castings and grates, and a second tempering shop for the oven-door glass.

Test	Bramwell's answer
1. Alignment	Yes. The prize page with the chair from Day 24
2. Collaboration	Yes. Five category teams named on Day 35, from both plants
3. Market conditions	Yes
4. The people with a say	Yes. The chair on Day 24, every supplier on Day 30
5. Risk	No. Nine items from a single source, $19.6 million, not one written plan

RUNNING IT WITH THE TEAM

These are three short sittings, and the order matters more than the length. The prize takes an hour with the chief financial officer and the analyst, drafted from the ledger before the spend file exists and redone the day it ties. The readiness tests take one leadership meeting with every function head in the room, plant managers included. The charter and the letter take an afternoon for the chief executive, the chief financial officer and the head of purchasing, and nobody else holds a pen.

Open the leadership meeting with the Day 6 question, before anyone has seen a figure. Each person writes down what the company spends with suppliers and where the number came from, and then you read them out. The spread makes the case for everything that follows, and it lands harder when the room produced it than when you announce it. Then the prize, then the five tests, then the charter. The letter comes last, because it makes promises the charter has to keep.

Say one thing at the start. We are not here to take a percentage off everyone. We are here to find the few decisions that hold the money, and make them deliberately. Say one thing at the end, after reading each no aloud with its owner's name: a no with an owner is a plan, and a no without one is the excuse you'll hear in month six.

The chief financial officer checks four things before anything is signed. The multiple on the page is the one the owner paid, not a hopeful one. The contribution figure is finance's own, not the average margin. The charter says in one line who signs a saving. And the cash it takes to pay every supplier on the day promised has been worked out, because once that promise is in the letter it can't come back out.

What goes wrong the first time? Someone writes a target on the prize page, usually the biggest number on it, and the program spends its first year defending a guess. The readiness tests drift into a discussion and come out as "mostly yes." The letter goes to legal and comes back as three pages nobody at a supplier reads to the end. And the charter names a committee as owner, which means nobody. Keep the page to a page, the letter to a paragraph and every owner to one name.

THREE QUESTIONS FOR MONDAY

1. If you put the Day 6 question to your leadership team this week, how many different numbers would come back, and how many supplier names?

2. What is 1 percent of your spend worth at the multiple your owner paid, and has anyone on your board seen that figure?

3. Which of the four promises would be hardest to keep from next month, and what would keeping it cost in cash?

BEFORE YOU MOVE ON

You should now have, on paper:

- Worksheet 1 — your prize page: direct, freight and indirect spend beside EBITDA, the 1, 3 and 5 percent lines at your multiple, and no target
- The new-sales line, built on finance's contribution figure
- Worksheet 2 — a one-page charter with scope, owners and the counting rule, signed
- The letter with its four promises, sent only after finance confirmed you can pay on the day
- Worksheet 3 — the five tests answered yes or no, and every no owned and dated on the charter
- Two names on the spend file, and the exports requested