Supplier Management Strategy

How Segmenting Supplier Types Can Improve SRM Efficiency 10x

Graphite Partners

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Introduction

How engaged are you with your supplier base?

The suppliers you use and your relationship with them have a major impact on your business, with a direct effect on your level of service and revenue. Despite this, many companies don't have an accurate figure for how much they spend each year, let alone who they spend it with. That's why we recommend companies have a robust Supplier Relationship Management (SRM) programme in place. As part of that programme, a key step is **supplier segmentation.**

What is supplier segmentation? Put simply, it is the practice of splitting your suppliers into different categories that you can then use to effectively monitor and manage them. It's an essential part of structuring your SRM and enables you to identify your critical suppliers, set expectations, and get the maximum value from your relationships.

SRM is useful for businesses of all sizes. While typically used by bigger companies, all businesses can benefit from a greater knowledge of their suppliers. Sure, larger organisations usually have the infrastructure to get the biggest advantage from the process, with job roles dedicated to sourcing and supplier management as well as the necessary purchasing power. After all, it might be hard to get a meeting with a supplier's CEO if your spending only accounts for 0.01% of their turnover. However, it's our experience that whether you're spending thousands or millions, a deep awareness and strong relationships with key suppliers is beneficial to every business.

Why segmentation?

While suppliers have a significant impact on your business, not all suppliers will have the *same* impact. Unless you only deal with a handful of suppliers, you'll need to divide those suppliers into relevant and manageable categories.

As long as you're treating all suppliers the same way, you'll be unable to allocate the right resources to the right supplier. Key suppliers may go ignored, while minor suppliers may take up too much of your valuable time. Proper classification allows you to put your attention and resources in the right place.

The majority of companies only think about their suppliers at two points; either when it's time to sign a contract, or when there's a problem. Of course, it's important to analyse your suppliers when it's time to renew contracts but, if that's the only time, then you're going to run into problems. Splitting your suppliers into categories makes it easier to manage any risks, avoiding potential disruption and keeping your customers happy.

Even if you somehow manage to avoid any significant issues, there's no way you can get the most from your suppliers if you only think about them once a year. Segmenting your suppliers gives you a better understanding of them and how they align with your business. It enables you to identify trends (both positive and negative), as well as additional opportunities.

Most importantly, proper categorisation enables you to connect what you spend with the value it creates for your business. You can see exactly where the value is in your supply chain. As a result, you'll then be able to make smarter purchasing decisions, without any unforeseen negative consequences. Beyond simply cutting costs, segmentation allows you to identify innovative solutions, engage with the suppliers who really make a difference to your company, and remain competitive.

Common challenges with segmentation

While the benefits of classifying your suppliers are clear, implementation isn't always a straightforward process. The first challenge is **recognising the need** for segmentation. Effective management depends on input and backing from many different parts of the organisation, from frontline management through to the C-suite. If there are people in your business that still believe you can get away with treating all suppliers equally or simply reviewing them individually on a case by case basis, then it'll be much harder to benefit from a segmentation programme.

Secondly, it's essential to segment based on **the right criteria**. How exactly should you divide your suppliers? What are the key factors? Are they all equally important? Are they objective, or are they based on personal preferences or perceptions? We'll cover this in the next section.

Finally, the biggest challenge is actually acting on the results. Segmentation, in itself, provides zero value. Rather, the **actions** that are derived from the process are what drive the benefits. For segmentation to be worthwhile, it simply can't be a paper exercise that's carried out once then filed away. Instead, it has to be done with the objective of revealing where you need to put time, effort, and other resources into your supplier relationships. By the end of this white paper, you'll be given clear guidance on what to do with the information you uncover.

How to effectively segment your suppliers

The first step to effective segmentation is to determine the criteria you're going to use.

A common method is to classify based purely on spend. While spend is an important part of analysing your suppliers, it's far from being the only factor. There are many different criteria you can and should consider, and limiting it to just spend will leave out key metrics that can have a significant effect on your business performance.

From experience, we've found the most effective solution is to break supplier performance down into two key criteria, each made up of several contributing factors:

Supplier Impact. This covers, among other things, your current spend with the supplier, as well as your level of dependence. Are they easily replaceable? What kind of disruption would changing suppliers cause?

Strategic Contribution. What is the strategic importance of this supplier on your business? What effect do they have on your competitiveness? Do they consistently deliver at expected levels? Do you anticipate future spend to increase or decrease?

This model was originally used for segmenting suppliers in the IT industry, but it can be used (with some minor tweaks) in any industry to get a comprehensive picture of your supply chain construction.

This may sound good, but how do you actually score them?

Prioritising your suppliers

Before going any further, we highly recommend using a Pareto process to focus your efforts, rather than attempting to break down every one of your suppliers into different categories. Focusing on the suppliers that represent the top 20% of your total supplier count gives you the best opportunity for significant returns. In order to do this:

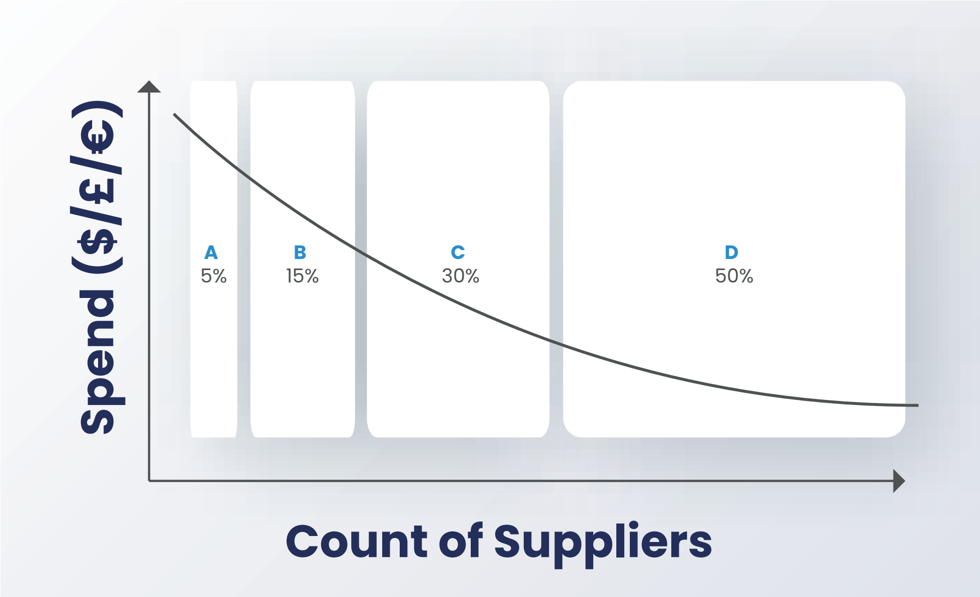
1. Rank all suppliers from highest to lowest spend
2. Take the top 20% of that count (eg. If you have 500 suppliers, this will be the top 100 suppliers) and classify as your 'priority suppliers'
3. Break down this group by spend, as below

Segmentation by spend

Once you've identified your priority suppliers, you should now divide those suppliers into four equally sized groups, each accounting for roughly 25% of the total spend (e.g. If you spend £1bn with your priority suppliers, each segment will represent ~£250mn). You've now identified your Extreme, High, Medium, and Low spend suppliers within your priority group.

In our example, the Extreme group makes up 25% of our priority spend, but only represents 5% of the supplier count. These values will vary depending on the distribution of your spend in your unique procurement scenario.

A = Extreme
C = Medium
B = High
D = Low



Of the companies that have embraced segmentation, this is where most of them stop.

That is a mistake.

While this is an important step and is better than no classification at all, assessing suppliers against additional criteria brings far greater benefits.

Evaluating relationship impact & business value

For your segmentation to be worthwhile, your supplier assessment has to be based on objective criteria that affect your business, not your gut instinct or who you enjoy playing golf with on the weekend. Additionally, while there are many criteria, they are not all equal.

For the best results, we need to evaluate the right criteria, with each one properly weighted.

Supplier Impact

We recommend measuring a supplier's impact by measuring the following:

Current Annual spend. Which tier are they in, from our above segmentation? Accounts for 10%. NOTE: That's right, annual spend only accounts for 10%. One of the most common mistakes businesses make is putting too much importance on annual spend, usually accounting for 80, 90, or even 100%. As we'll see, there are many more factors to consider.

Impact on revenue in the event of a disruption of more than 24hr. What would be the effect on your revenue if the supplier disappeared tomorrow? For example, you might be able to survive without your stationery provider for more than a day, but if your card payment processor went down you could be out of business. Divide your suppliers into rankings of Low, Medium, High, and Extreme. Accounts for 20%.

Impact on reputation in the event of a disruption of more than 24hr. For most companies, their reputation is just as important as their revenue. For example, a large national railway operator uses processes and software supplied by Graphite Partners to ensure their train carriages are up to standard and to keep customer satisfaction high. Rank your suppliers' impact as either None, Minor, or Major. Accounts for 20%.

Time needed to restore service with another provider. What kind of disruption would it cause to your business if you had to change suppliers? Some suppliers are easily interchangeable; changing a commodity supplier may be done quickly, but switching out an IT supplier might take longer. We recommend dividing them into time scales of Less than 24 hours, 1-29 days, 30-89 days, or More than 90 days. Accounts for 20%.

Does your spend account for more than 25% of their turnover? This is a simple yes/no answer. While many of these criteria help work out the relative importance of the supplier to your company, it's also important to know how important you are to the supplier if you want to negotiate from a place of strength. Accounts for 20%.

Switching costs for changing suppliers. These may be as obvious as contract cancellation fees, but there may be other costs you need to consider. For example, changing a software provider might not incur any penalty, but the deployment, testing and costs of any integrations could be significant. Divide your suppliers into rankings of Low, Medium, High, and Extreme. Accounts for 20%.

Strategic Contribution

For measuring a supplier's value to your business, both now and in the future, we use these questions. You'll notice most of these are straightforward Yes/No questions. As such, they may seem simpler to assess, but it's important to still be objective with your answers.

Is the pricing competitive? When answering this question, you should also consider your future anticipated growth. Their prices may be competitive for now, but will that still be the case when you need to increase your order size? Yes/No. Accounts for 25%.

Are they consistently meeting agreed service levels? They may have promised the world in the contract, but are they keeping their promises? Yes/No. Accounts for 15%.

Do they have access to confidential information? Do they have knowledge of your systems and processes that you wouldn't want to be shared with your competitors? Yes/No. Accounts for 5%.

Do they enhance your competitive position? Are they your 'secret sauce' that help you stand out and deliver a superior service? Yes/No. Accounts for 10%.

Does their service align with your long-term strategy? Are they a quick-fix supplier, or do you see them playing a significant part in your future growth? Yes/No. Accounts for 25%.

Do you anticipate your spend with this supplier to change? Is your spending likely to increase, stay the same, or decrease? Accounts for 20%.

By asking yourself these questions for each of your top suppliers, you now have a score for both their supplier impact and strategic contribution. To make the process quicker and easier, we highly recommend using a weighted decision matrix to automatically score your suppliers.

Identifying opportunities with the segmentation model

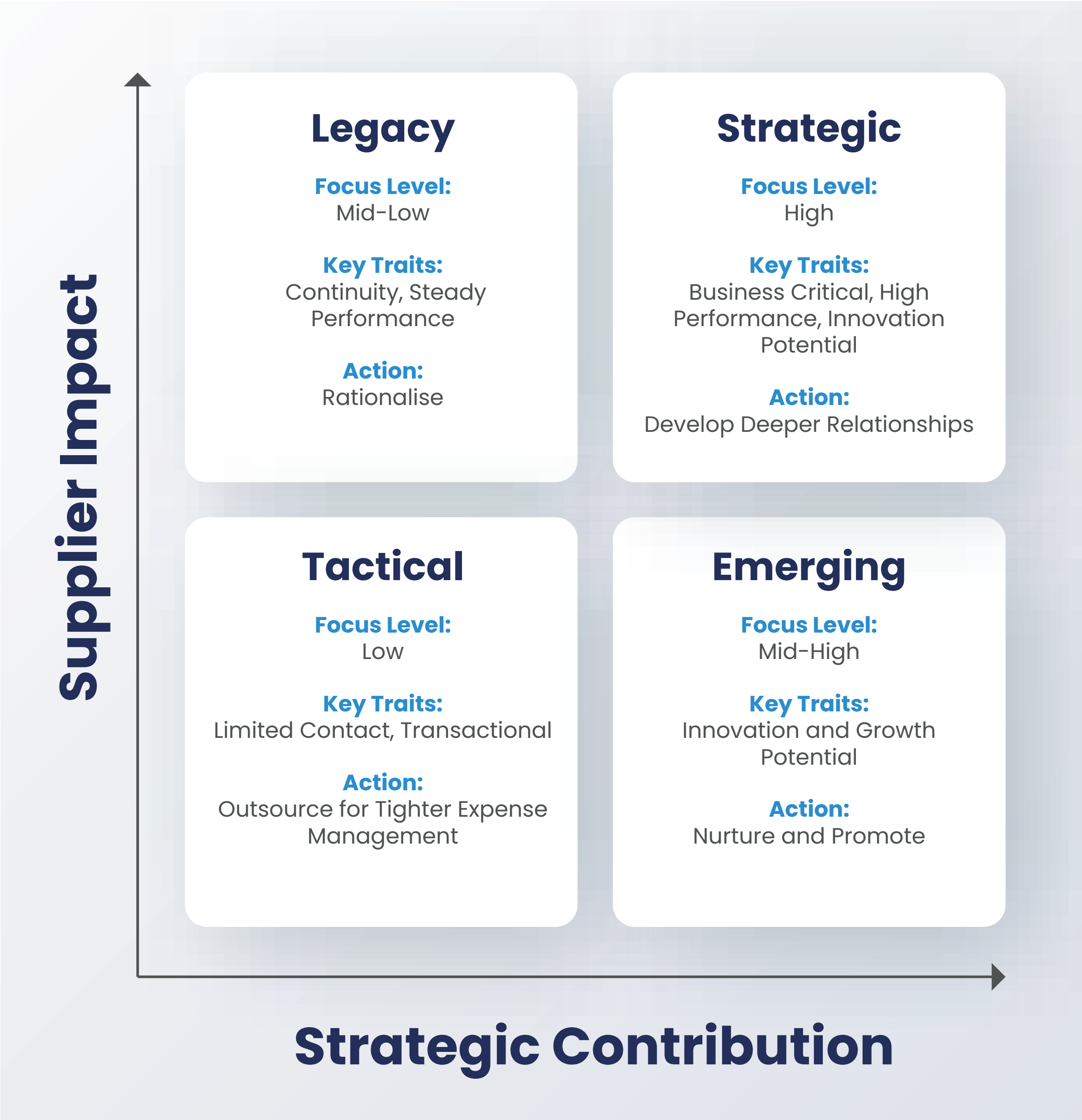
You can now use your scores to see how your suppliers compare with each other. When plotted on a graph, they'll now fall into one of four potential categories.

Strategic - These are your VIPs, the important suppliers that tick all the boxes, both for relationship impact and business value. They provide essential services throughout your organization, possibly across multiple categories. As a result, this is where most organisations will look for cost-savings first. To get the most from this sector, you should run regular focus groups and joint projects.

Emerging - Suppliers that fall into this group may not seem as important at first, as they have less of an impact on revenue. Don't be fooled; this is where most of your savings programs will come out of. These suppliers are usually interesting and innovative, and investing in these relationships can have big results. Consider how emerging suppliers can disrupt legacy/tactical suppliers and become strategic.

Legacy - These suppliers are highly embedded in your business but despite this offer less value. Maybe they've gotten lazy due to a lack of any real competition, or it's too expensive to switch, and they know it. Either way, they have the potential to cause massive disruption to your business, but you're not planning on spending any more with them anytime soon. You shouldn't expect to get significant savings here. Focus on simplifying engagements to reduce costs.

Tactical - Low impact and low value. Typically this sector will be mostly commodity suppliers. All the contracts look the same, with little to differentiate suppliers. Even though it's easy to switch, it's not usually worth your time and effort. Instead, consider outsourcing these to a procurement agency. Think about setting performance targets (KPIs) and penalising for poor performance.



The segmentation model makes it easy to see at a glance where you should be paying attention, especially when you compare them against your company's current spend. For example, Emerging or Strategic suppliers who are also in the Extreme spend bracket are worth investigating further. While you can normally ignore Tactical suppliers, look out for any who are also in the Extreme spend bracket as in this case even a minor saving can have a big impact.

However, as interesting as all this is, segmentation is a way to identify and classify your suppliers for improved management. It has to be followed by action if you're going to benefit from the exercise.

Governance

With an objective, precise score for where each supplier lives in the segmentation model, it's now time to use that information as part of your supplier management program. By using this information to decide how you're going to manage your supplier relationships, you can invest the necessary resources to get the most from your high-value suppliers, while still not wasting time on any unnecessary meetings.

Many businesses meet with their suppliers just once a year, and usually as a tick-box exercise without any clear objective. Instead, we recommend using your classifications to set a stronger cadence, with more touchpoints and more opportunities to deliver against agreed commitments for both sides.

In line with our model, review meetings should be divided into three different types.

Operational - These are meetings designed to address any existing issues and efficiencies, usually led by front-line management (as opposed to Procurement). These are your initial source of information. They should be official meetings and aren't replaced by necessary communication for day-to-day operations.

Performance - Here is where you evaluate your supplier's performance against your existing contracts and agreements, ensuring the supplier is meeting established KPIs. These are usually Procurement led.

Strategic - These are carried out with senior-level management and ideally C-Suite executives, with the objective of strengthening alignment and relationship. Your focus will be on the supplier's impact on your performance. For these to be worthwhile, both operational and performance issues should already be resolved through the above meetings.

How often?

We can now objectively measure how often we should be meeting with each supplier based on their category, and what kind of meetings they should be. For example, strategic reviews are unlikely to be needed as often for your tactical suppliers as they are for your strategic suppliers.

Here's our recommendation for each category, assuming sufficient resources.

Emerging - Monthly
Strategic - Quarterly
Legacy - Six monthly
Tactical - Annually

In each case, we recommend bundling your operational and performance meetings together and doing them at the same time, then carrying out a strategic review for the next meeting, then cycling between the two.

Who should attend?

When carrying out your review meetings, it's important that the right people are in the room. Successful implementation depends on getting key stakeholders involved, rather than having Procurement working on their own. This varies both by the type of meeting and the supplier classification.

When arranging these meetings, you should match the stakeholders between your company and the supplier. For example, if your C-Suite is going to be present, the supplier's C-Suite should be too.

While the specific titles will likely vary across different businesses, here are the people we recommend are involved in each review:

	Strategic	Legacy	Emerging	Tactical
Operational	Key Business Stakeholders Contract Management Risk/Security Finance	Key Business Stakeholders Contract Management Risk/Security Finance	Key Business Stakeholders Contract Management Procurement Finance	Key Business Stakeholders Contract Management Procurement Finance
Performance	Category Lead Key Business Stakeholders Contract Management Finance	Category Manager Key Business Stakeholders Contract Management	Category Manager Contract Management	Key Business Stakeholders Contract Management Procurement Finance
Strategic	Chief Procurement Officer (CPO) Category lead, C-Suite, and Key Business Stakeholders as required.	CPO Category lead C-Suite and Key Business Stakeholders as required.	Category manager Category lead, CPO, and other C-Suite / Key Business Stakeholders as required.	Key Business Stakeholders Contract Management Procurement Finance

Maintenance

The only constant in life is change, and that applies to your suppliers and their segmentation too. Suppliers that may have once been Emerging may become Strategic. Strategic may become Legacy.

Sudden disruption to an industry or lack of availability can turn your carefully categorised supplier list upside down, changing literally overnight. The Covid-19 pandemic has made this apparent, where remote team management tools and hygiene management solutions suddenly became essential to businesses' revenue and reputation.

It's important to remember, however, that there doesn't need to be a worldwide event for you to review your supplier segmentation. Changes happen all the time, due to both internal and external factors affecting you and your supplier. New suppliers are being launched all the time, while others fail. Contracts change, as do standard business practices.

Do you know the current distribution for all your current suppliers?

To ensure you're consistently getting the most out of your suppliers, you should embed segmentation into all parts of your supplier approval and review process. Make sure you're meeting with them at the appropriate intervals, with the right people in the room, and don't be afraid to reassess and reevaluate your suppliers, ideally before there's a massive disruption.

What next?

So you've split your suppliers into distinct groups and used that information to set the right meeting cadence with the right people in the room. You're also committed to regularly reviewing your suppliers to ensure your categorisation is still accurate. What comes next?

First of all, you may find that you need to adjust your approach to segmentation for your particular business. While our recommendations are based on our experience in various industries, the questions you ask, the criteria you track, and the weighting you give to each factor may vary for your unique operation.

Remember, this was an analysis of your top 20% of suppliers (your priority suppliers). What about the other 80%, your standard suppliers? Rather than going through the segmentation process again, we advise you to focus your efforts on getting as much spend with your standard suppliers across to your priority suppliers. Look for crossover opportunities, so you can reward your priority suppliers with incremental business from the tail spend of your supply chain. As a result, they'll also be much more open to negotiating favourable terms.

A common mistake for businesses is to focus purely on where they can cut costs. Instead, better results can usually be had by adding value. Saving 2% on your bills is great, but adding 10% value to each transaction is even better.

Finally, never forget that segmentation is not a magic bullet. By itself, dividing your suppliers into categories does not provide value. Rather, it's the execution of meetings, the discussions, and follow-through on deliveries that makes a difference to your business.

By correctly segmenting your suppliers and having a regular cadence of meetings, you'll be able to be more targeted and, rather than wasting your efforts, you'll benefit from an improved ROI.

About Graphite Partners

Creating value through simplification and automation

Graphite Partners helps medium-to-large companies optimise their businesses by improving their operational workflows, transforming their procurement systems, and implementing the resources they need for ongoing success.

Working with Graphite Partners means access to our team of experienced industry experts, as well as our large network of partners and service providers. Today we work with clients across a wide range of industries including such fields as transport, logistics, hi-technology, and help them take their business to the next level.

If you found this white paper useful, why not join the discussion with us on LinkedIn?

If you need help implementing your SRM strategy or are considering your approach to the subject for the first time, Graphite Partners can support you. Head to our website to request a consultation with a member of our team, or contact Steve Brown direct via email steve.brown@graphite-partners.com.

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