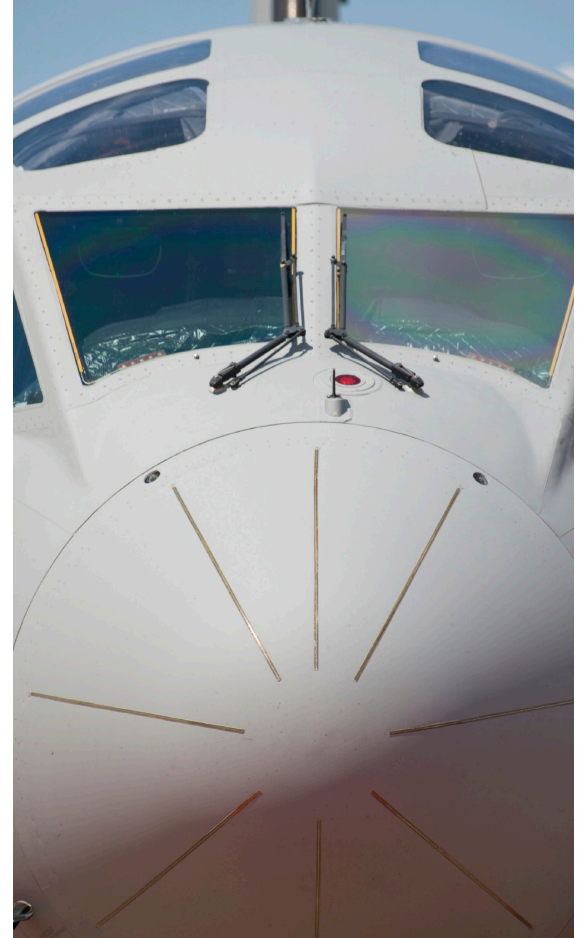




Breaking down the barriers to sourcing services in the A&D industry

Unlocking the tremendous savings potential in services spend



The aerospace and defense industry has undergone dramatic change in recent years, yet its procurement practices have not kept pace. While other industries have adopted new approaches to reduce costs — and been handsomely rewarded — procurement at many A&D companies remains tied to the past, driven by a program-centric, cost-plus mentality as well as other traditional business practices that are increasingly dated.

Cost pressure

These old procurement practices are being used at a time when A&D companies face increasing cost pressure in both their government and commercial businesses.

On the government side, cuts in military spending and a heightened focus on managing more than \$295 billion in cost overruns reported by the Government Accountability Office¹ is forcing program managers to either reduce costs or risk having their programs slashed or cancelled.

Meanwhile, on the commercial side, tight credit markets spurred by the financial crisis have caused orders to decline precipitously, placing an even greater emphasis on the profitability of existing orders.

To meet these challenges, A&D companies must find new ways to reduce costs. Procurement practices that were acceptable a few years ago simply aren't good enough today.

Sourcing services

The need for new ways to reduce cost is particularly true for spend on external services, including everything from contract labor and telecom to legal and facilities management. Although some A&D companies are making significant progress on parts sourcing, most have had little or no success on services sourcing.

In our experience, the main obstacle is getting visibility into how service dollars are being spent. Most A&D companies know that roughly 25% of their external spend is for services. What they don't know is exactly how all of that money is being spent. What services are being purchased? Who are the suppliers? And how can services be procured more efficiently, for less money?

It's relatively easy to get started on parts sourcing because parts are tangible and can be precisely specified. Services, on the other hand, are harder to define — and even harder to manage and measure.

¹ U.S. Government Accountability Office (GAO) Testimony Before the Committee on the Budget House of Representatives (March 25, 2009).

The good news is that the challenges associated with services sourcing — although seemingly overwhelming — are actually quite manageable. This report examines the unique challenges of sourcing services, and describes a robust approach for A&D companies to consider in their efforts to save money and get more value from their services spend.

A huge, untapped opportunity

For most A&D companies, services account for about 25% of external spend. A mid-sized company with \$10 billion in revenues, can easily spend more than a billion dollars a year on services. (see Figure 1).

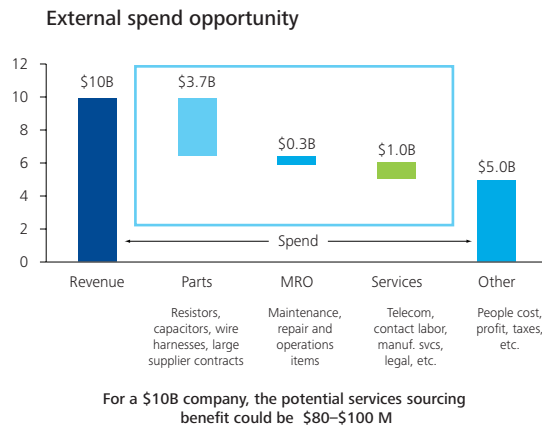


Figure 1: Typical cost savings

In our experience, improved sourcing can reduce services costs by \$80–100 million for every billion dollars of Spend. That kind of opportunity is simply too big to ignore.

Barriers to improvement

When thinking about improving how they source services, A&D companies typically run into three major barriers that prevent them from extracting value from services spend.

- *Complexity.* Improvement initiatives often are derailed by the fact that services are less tangible than products, which makes them more complex to define and manage. Since services cannot be specified with the same level of precision as parts, many companies jump to the conclusion that improved services sourcing is very difficult.
- *Fragmented spend.* Spend on services tends to be scattered throughout the enterprise. Different programs or business units use different suppliers and different procure-to-pay (P2P) applications, which makes it hard to manage services spend in a coordinated way.

- *Poor spend categorization.* Most A&D companies know how much they spend on services as a whole. Unfortunately, that aggregate figure is not particularly useful. What companies need is detailed spend data organized into meaningful supply market categories such as computer services, contract labor, legal, telecom, and facilities maintenance.

These three barriers can prevent A&D companies from getting sufficient visibility into their services spend. And without that visibility, it's hard to improve the procurement process and negotiate better deals.

The cost plus mentality combined with strict acquisition regulations have historically discouraged A&D companies in focusing on cost reduction efforts. With more contracts now moving to fixed price, companies are beginning to look at materials and services cost reduction.

Five steps to better services sourcing

Sourcing services efficiently and effectively is more challenging than sourcing parts. However, it can be done. It just requires the right approach. Here are five steps we believe A&D companies should consider in their efforts to reduce their service costs while improving overall service levels (see figure 2).

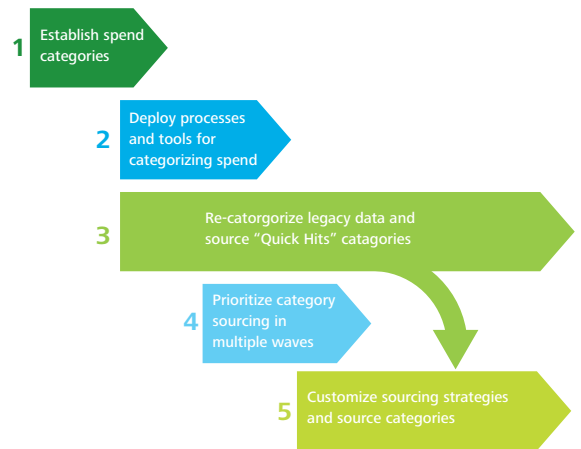


Figure 2: A five-step approach to improved services sourcing

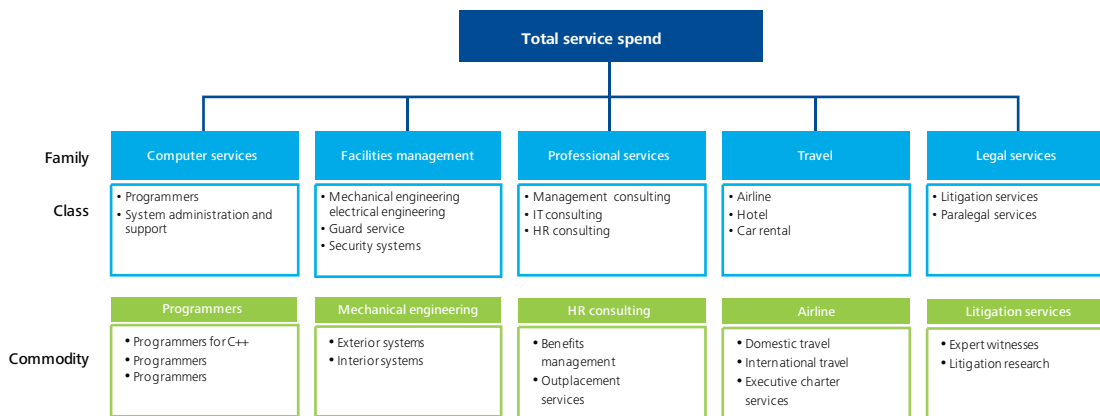


Figure 3: Part of the UNSPSC Taxonomy

Step 1: Establish Spend categories

The starting point for improved services sourcing is to establish a comprehensive set of spend categories. This might seem like an insurmountable task. The good news is most of the work has already been done.

A multi-tiered service taxonomy called the UNSPSC (United Nations Standard Products and Services Code) has already been developed and is being widely adopted in A&D and other industries. This taxonomy includes more than 5,000 Spend categories that cover virtually every service imaginable. The categories are organized into four levels of detail—segment, family, class and commodity. Companies can choose whatever service categories and levels fit their specific needs (see figure 3).

If procurement staff have to wade through thousands of spend categories in order to assign the right one, they probably won't do it. So the main challenge in this step — once you have decided to adopt a taxonomy — is to pare down the comprehensive set to include only services and detail levels that apply to your business. The rest can be deactivated (see figure 4).

Categorization map (Total of about 400 codes activated)

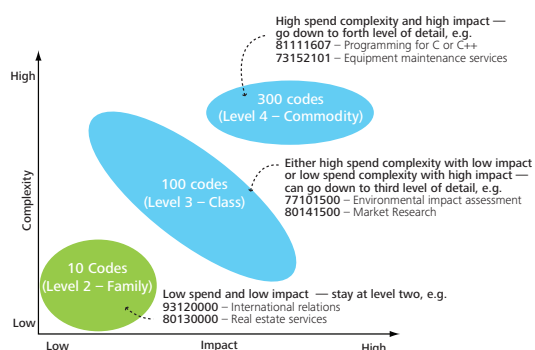


Figure 4: Streamlining the categories

Complex, high spend services are more likely to be defined to the fourth level of detail. For example, if C++ programming is a service that is expensive and critical to your business, you will probably want a spend category that captures as much detail as possible. Other services can be grouped into less detailed categories, so you don't end up with an overwhelming number of categories to manage. Most A&D companies are likely to end up with 300–500 spend categories, which is much more manageable than 5,000.

This step is critical to ensure that the procurement buyers use the right taxonomy to categorize spend. While most companies have an existing taxonomy, the codes are misaligned or not entered because of the effort in finding the right code. The process of streamlining the category codes makes it easier to find and enter the right code for the spend.

Step 2: Deploy processes and tools for categorizing spend

After you establish your services taxonomy and spend categories, the next step is to develop and deploy a process and tools that enable Buyers to efficiently categorize their service spend. Users should be able to enter costs into the appropriate categories quickly and easily, rather than plowing through screen after screen of irrelevant category code options.

To facilitate consistency across the enterprise, user training should be a top priority. If Buyers struggle with the process and systems, they are more likely to enter bad data or give up completely — which is why most of the legacy spend is typically categorized as Other, with a high level category code, or categorized incorrectly.

Step 3: Recategorize legacy data and source Quick Hit categories

Once the system and process to categorize future spend is up and running, it can take a couple of years to accumulate enough data to act on. The good news is you can jumpstart the process by categorizing legacy spend data. This not only can help accelerate the benefits, but also validate that the selected categories make sense for your business. This step can take time but the benefits can significantly outweigh the costs

Step 4: Prioritize category sourcing in multiple waves

Analyzing the historical data provides a solid basis for prioritizing and phasing your improvement activities. In the analysis, each high level spend category is evaluated to determine the overall potential for savings from improved sourcing.

Prioritization is based on the estimated savings and expected difficulty of improving sourcing in each spend category. Categories with low implementation complexity and high savings potential get a higher priority. Figure 5 shows a typical prioritization analysis, with the improvement roadmap divided into three waves.

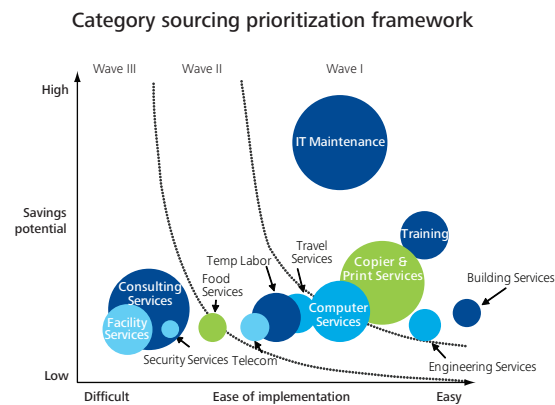


Figure 5: An improvement roadmap

Proper phasing can accelerate the benefits and help the improvement effort fund itself.

Improved Sourcing for Contract Labor

Contract Labor is a major source of Services spend for many A&D companies, and offers significant opportunities for savings.

This service category is often managed internally, using processes that are costly and inefficient. In many cases, staffing agencies are not rationalized, and there is high variability in pay and markup rates for the same positions within the same territory.

Effective strategies

Competitively source both Master Service Providers (MSP) and staffing agencies:

Outsourcing — Outsource the management of Contract Labor to an MSP. For example, activities such as sourcing staffing agencies, on-boarding, training etc can be outsourced. Use vendor management systems (VMS) technology to enable savings and process improvements

Volume aggregation — Consolidate buying power to get better rates from a smaller number of staffing agencies, then transition those suppliers to an MSP to manage. Force agencies to continuously compete on price and service level.

Price benchmarking — Shift from internal price benchmarking to market-based benchmarking

Bottom-line benefits

Based on our experience, improved services sourcing can deliver annual savings of up to 12-18 percent. It can help standardize and streamline the contract labor hiring process. Also, it can produce higher service levels (better fill rates and faster time to productivity), and provide an opportunity to increase diversity spend.

Step 5: Customize sourcing strategies and source categories

Some sourcing strategies apply to all spend categories. For example, competitive bidding is generally a smart move, particularly once you have categorized data to help you get the best price. Even if you are happy with your current vendor and don't want to switch, competitive bidding can help you negotiate a better deal.

Similarly, it is always a good idea to eliminate waste through rigorous demand management.

Improved sourcing for telecom services

Telecom is often one of the largest sources of indirect spend, making it a top concern for CIOs and CPOs alike. Spend in this area continues to rise, primarily driven by increased use of wireless services.

Most A&D companies have complex networks and fragmented service portfolios with multiple, redundant carriers. This complexity provides opportunities to optimize usage and supply.

Competition is driving prices down, yet many companies are not consistently taking advantage of this trend. Across most organizations, there is significant variance

Effective strategies

Competitive sourcing — Seek competitive bids, instead of blindly relying on sole sourcing. Use a rigorous methodology to build transparency into pricing across every service in the telecom portfolio

Network optimization — Reduce needless waste, and then align network bandwidth with actual usage – instead of paying for more than you need

Unbundling wireline and wireless — Most carriers have not yet integrated their businesses across these services, which means it is often cheaper to handle them separately

Billing reconciliation — Validate the accuracy of billing compared to contract rates.

Air cards — Consider issuing wireless data cards to frequent travelers to avoid paying exorbitant daily internet fees at hotels

Bottom-line benefits

Based on our experience, improved sourcing can deliver savings of up to 10–25 percent for wireline services, and up to 5–15 percent savings for wireless services. Also, new master services agreements can provide greater flexibility, making it easier to adapt to rapidly changing market conditions.

However, beyond those universal best practices, different spend categories often require different sourcing strategies. When designing a customized sourcing strategy, we believe there are four major variables to consider.

Internal process costs — If the internal cost of managing and administering a particular service category is high, it might make sense to outsource those management activities to a third party. For example, if your internal process costs for contract labor are too high, you can hire a Master Services Provider (MSP) to work with the staffing agencies and to manage the ongoing agency contracts and relationships. MSPs can generally manage and administer these activities more efficiently due to their specialized expertise and economies of scale. (see sidebar: “Improved Sourcing for Contract Labor”)

Total cost of category management — Of course, the larger goal is to minimize total services costs, not just internal process costs. There are many ways for A&D companies to directly reduce services Spend, such as: competitive bidding to reduce base rates and mark ups; creatively bundling services to aggregate demand and obtain volume discounts; and even reducing overall usage by changing how and when services are consumed.

We recently applied these kinds of strategies to help a company significantly reduce its Telecom spend. (see sidebar: “Improved Sourcing for Telecom Services”).

Industry fragmentation — If a particular service industry is highly fragmented, there may be opportunities to reduce costs by consolidating suppliers. Examples of service categories that are highly fragmented include contract labor, janitorial services, and facilities management. There are fewer opportunities for supplier rationalization in highly consolidated industries such as telecom, utilities, and small parcel delivery, which tend to be dominated by a few major players.

Commodity vs. custom — *Commodity* services are turnkey activities that can be clearly and easily defined. In contrast, *custom* services are complex activities that vary widely from one situation to the next and require significant supplier expertise and judgment. A single spend category might contain both types of services; however, each type requires a different strategy.

For example, A&D companies make extensive use of temporary computer programmers. In some cases, the programmers are like *commodity parts*. They are assigned clear, pre-defined tasks, and the customer is essentially buying a generic set of skills for a given period of time. Skill requirements for these commodity programming services can be communicated in a fairly standard job description.

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Improved Sourcing for Legal Services

Legal services is a complex spend category. As such, it typically has not been managed with as much rigor as other major spend areas. This creates significant savings opportunities.

Most A&D companies suffer from lack of standardization in this area. Across the organization, there often are a large number of firms providing similar services. There are few standard contracts, statements of work, or formal guidelines and fee models. Also, there is considerable variation in hourly rates, leverage models, and hours worked for similar types of legal matters.

Effective strategies

Competitive selection and pricing — Competitively source a select few qualified law firms by practice area and geography, using competitive data to set new bill rates and discounts

Operating Efficiency — Segment cases so work is assigned to the most effective resource (e.g., internal or outsourced; attorneys or paralegals; firms with a strategic relationship or “commodity” firms used for individual transactions). Use case management systems (CMS) technology to improve productivity and effectiveness

Firm management — Create a preferred counsel program using centralized procurement with standardized engagement letters and terms & conditions

Bottom-line Benefits

Based on our experience, improved legal sourcing can deliver annual savings of up to 7–13 percent. It can also help improve governance, spend transparency, and management of external counsel.

A volume aggregation strategy makes sense for commodity services, because all of the jobs have similar specifications (i.e., job descriptions) and therefore can be easily aggregated. Also, supplier bids for commodity services can be effectively evaluated on an apples-to-apples basis.

In other cases, A&D companies use programmers that are more like custom parts. They are hired to develop and deliver a specific application, but are expected to use their own expertise and judgment to determine exactly how the work should be done. Different programmers might perform different tasks to achieve the same objective, so defining and communicating the service is more complex.

A volume aggregation strategy doesn't make as much sense for custom services because the specifications vary too widely, making aggregation and apples-to-apples comparisons difficult, if not impossible. The most common way to reduce the cost of custom services is to negotiate a standard rate card with better rates. A more innovative approach is to try and demystify custom services, recasting them as a set of commodity services so a volume aggregation strategy can be applied.

Of course, computer programming is just one example of a custom service. Deloitte recently helped a client in their efforts to improve how it sources Legal Services, which vary widely and often require a high degree of expertise (see sidebar: “Improved sourcing for Legal Services”).

Taking action

Getting a handle on services spend is the main obstacle to improved services sourcing. But with the right approach, it is actually quite straightforward. And the results speak for themselves. A&D companies can save as much as \$80–100 million annually for every billion dollars in services spend. In the face of increasing cost pressure on both the government and commercial side, those kinds of savings are simply too big to ignore.

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