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Transforming Procurement at Merck (B)

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ABSTRACT

This case is a continuation of the Merck A case.

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This case was prepared as a basis for class discussion rather than to illustrate either effective or ineffective handling of a business situation.

Managing Strategic Relationships

In September 2005, GM won the bid for supplying Merck's western hemisphere fleet vehicles for the following three years. Bill Gibson and his team at GM had spent the previous few months in a continuous process of meetings and negotiations with Merck's sourcing team. GM's success resulted from many separate efforts but what ultimately won the deal was GM's willingness to have an open dialogue to jointly create a win-win solution with Merck.

SOURCING MANAGEMENT PROCESS AT MERCK

As part of Merck's procurement transformation, the purchase of fleet vehicles was identified as a key area for cost savings. The GPMC anticipated considerable benefits from consolidating the supplier base. The cross-functional Merck team that managed the project included representatives from Global Procurement, U.S. Fleet Administration, Latin America Finance, Canada Finance, Corporate Safety and Site Procurement. The key stakeholder was the U.S. Human Health Division (USHH) whose field-based sales personnel were the largest fleet vehicle users. Selection of these representatives reflected the need for internal alignment as a precondition for consolidating the supplier base.

Understanding the key stakeholder's business requirements was critical (Exhibit 1). The USHH Regional Business Group Sales Vice President's perspective was very clear: "Fleet is very important to sales. Our primary objectives are to have safe, reliable, good quality vehicles ... we do not use fleet as means to retain employees." Based on the business requirements of vehicle usage, type of vehicles, share programs and economy, the fleet team generated several contracting options (Exhibit 2). The team discarded potential options if the benefit was low, the risk was greater than the reward, or the implementation cost was excessive. The team also concluded that the chosen supplier would have to commit to significant pricing improvement throughout the region in order to win Merck's fleet business.

SUPPLIER CONDITIONING

In summer 2005, Merck's top Procurement executives held a supplier forum with senior supplier management from Ford, GM, and DaimlerChrysler to apprise them of the change in sourcing management. They articulated Merck's organizational readiness and commitment to consolidate the Western Hemisphere requirements and assured each supplier that the business would be awarded to the firm that earned it. They clearly communicated how Procurement had been transformed, and that regional offices were no longer working independently in sourcing fleet vehicles. The Senior Vice President Latin America Human Health told the suppliers: "Fleet is my largest capital expense and very important to me ... To me, fleet is like computers. Procurement needs to understand my requirements and then get me the best deal."

GM WINS THE BUSINESS

Vehicle models on the final evaluation list are in Exhibit 4. Ultimately, GM's success was conditioned in part on its competitors' approach to the Merck business. Chrysler's high-margin strategy led to its elimination early on in the process. Ford had a vehicle supply gap. It offered the smaller-size Fusion as replacement for the Taurus, but could provide little operating data, including cost. Also, fleet was no longer central to Ford's strategy and its financial offer on the Fusion was less competitive than GM's Impala. Compared to DaimlerChrysler and Ford, GM was very eager to win the business; it offered Merck significant value enhancements including significant price discount incentives.

A new selection criterion for fleet purchase was Total Cost of Ownership (TCO). Merck developed a cost model that included the purchase price/lease price, fuel cost, maintenance cost, net resale impact (gain or loss against book value), and any applicable manufacturer price discount/rebate incentives. Merck used the model to calculate the net present value cost for the entire automobile fleet during one refresh cycle. GM demonstrated a high degree of willingness to participate with Merck in this process and to quantify the value of additional features of its offer. For example, GM vehicles were equipped with an oil

life monitor system that warned drivers of a needed oil change – Merck’s current policy was to change oil each 3,000 miles. Using GM’s system, vehicles needed an oil change, on average, every 7,000 to 10,000 miles. At \$35 per oil change, Merck could gain \$0.5 million savings from this feature alone. As Gibson opined, “Just follow the instructions, and you get free money in your pocket.” Similarly, GM’s five-year 100,000-mile warranty, unmatched by competitors, translated into maintenance costs savings. GM also assured Merck of on-time delivery. In summarizing GM’s approach, Gibson said, “Squeezing the margins will not improve the relationship, because I have no more to squeeze.” By partnering with Merck on quantifying value-added features, GM was able to deliver a mutually beneficial solution.

The new procurement system changed Merck’s procurement criteria in other ways. Historically, USHH had rejected the Impala on the grounds that its brand perception was inconsistent with Merck’s image, despite it being favored by sales reps who were permitted to use their Merck car for personal use. By securing stakeholders’ buy-in on the strategic objective -- consolidating the supplier base to leverage Merck’s purchasing strength -- the sourcing team was also able to focus attention on features like safety and space (where Impala was judged to outperform other models). These insights, gained through the procurement process, helped GM’s efforts. An important outgrowth of the partnership process was Merck’s decision to shift vehicle procurement from an annual to a three-year cycle. That provided Merck and GM with the opportunity to build a more sustainable, value based strategic relationship between the companies through its Supplier Value Management (SVM) process. The U.S. sales force was generally pleased with the prospect of switching from driving the Taurus to the Impala. They also appreciated the operating savings from better fuel economy and lower maintenance.

Merck believed the new arrangement would earn it significant expense and capital savings. GM agreed to issue a signing bonus based on a projected total purchase volume. If Merck’s total actual purchase volume fell short, it would repay GM any unearned portion of the signing bonus on a pro-rata basis. Going forward with the strategic relationship, both teams agreed to meet periodically to maintain the momentum built during the RFP process. These meetings would seek to address issues resulting from the fleet operation via policy, guidelines, internal communication, and supplier management. The teams would work together to continuously review their understanding of Merck’s business requirements and vehicle specifications and strive to make key decision elements quantifiable and measurable.

Going forward, Merck’s Procurement team sought to maintain a presence in the marketplace and build best-in-class supply intelligence to keep its fleet purchases competitive. It planned to attend trade shows and industry conferences, to visit GM’s and potential suppliers’ plants to understand their processes and costs, to gain an understanding of the automotive industry supply chain, and to build and develop an internal center of excellence in fleet sourcing. It also sought to benchmark best practices in fleet vehicle sourcing using GM’s expertise to identify best-in-class companies operating large fleets. Procurement would conduct supplier performance reviews with GM to ensure that GM met/exceeded Merck’s business requirements, and was properly recognized for its performance – good or bad! By end 2006, most of these practices were put in place and Fleet Financials did a cover story on Merck’s Supplier Value Management (SVM) initiative with GM (Exhibit 4).

The Future at Merck

At the Reuters Health Summit in November 2006, Richard Clark, said, “I think we're getting some of our swagger back as a company.” Merck had beat earnings forecasts in recent quarters, and had achieved its twin goals of climbing back to a pre-Vioxx share price and a market capitalization of \$100 billion. In 2006, Merck announced a *Plan To Win* that included an expected combined cost savings of up to \$5 billion through 2010 from manufacturing improvements and elimination of 7,000

jobs -- 11 percent of its staff -- while holding down costs of research, marketing and administration. The *Plan to Win* included completion of the \$1.2 billion savings derived from the company's cross-functional procurement efforts, which Richard Spoor and the GPMC delivered by March 2007 (21 months ahead of schedule). Upon achieving this milestone, Spoor then committed to an extra \$1 billion savings for Clark by 2010.

GP believed that future cost savings would be more difficult to secure; it had already taken the low-hanging fruit from supply base consolidation and price improvements. Nevertheless, it believed it could sustain three to-five percent annual savings by continuous improvement (based on benchmarking several industries that had created and sustained cutting edge procurement practices). But it would also seek breakthrough strategies worth 20% or more in savings. Future efforts would increase spend compliance, widen the pie including R&D procurement outsourcing initiatives and greater focus on strong regional procurement groups in EMEA and Asia Pacific. GP would also seek changes in policy and business processes. For example, in the U.S., Merck succeeded in consolidating nine different travel policies into one, avoiding confusion, escalating costs, and non-compliance. However, there was no stated penalty for travel policy violation, in part because the tracking system was inadequate. Globally, the situation was even more challenging due to use of multiple travel agents and corporate cards within regions. There was still plenty of work left to do in the transformation process.

Exhibits

Exhibit 1 Business Requirements from OEM Suppliers

	Description	Comments
Assurance of Supply & Regulatory Compliance	<ul style="list-style-type: none"> Capacity must be available Ability to ramp up and ramp down capacity Ability to deliver requirements both when and where Meet regulatory compliance, where applicable Ability to meet environmental and like ethics needs Ability to fulfill safety requirements 	<ul style="list-style-type: none"> Supplier needs to be financially sound for the next 3-5 years Union contract negotiation needs to be clearly monitored, and contingency plan must be developed in case of a major strike Merck will be apprised of new vehicle introduction dates and model year shutdowns as the news breaks Standard vehicle delivery time is to meet the six to eight week lead time to which we have become accustomed
Quality	<ul style="list-style-type: none"> Quality in design of goods and services Quality in meeting specifications Reliability of product or service 	<ul style="list-style-type: none"> Extended warrantee for life of vehicle (36 month or 65,000 miles) Institute a vehicle "lemon law." Set and agree to parameters Standard Merck required safety features at no charge Major recalls can be viewed as breach of agreement Dependability, reliability and functionality – best in class
Service	<ul style="list-style-type: none"> Ability to commit to lead times and order flexibility Ability to interface with data management systems Help desk/call center capabilities match needs Dedicated account manager where needed Show continuous improvement capability 	<ul style="list-style-type: none"> Rental or loaner vehicle availability at no charge when lease vehicle is in for service (Brainstorm how this might be facilitated; Deal is with the OEM, yet the dealer would be responsible for the rental unit) "Three year test drive" which includes free wiper blades, free oil changes, free tire rotation and free fluid changes – All in pricing, compared and contrasted to current scenario
Cost	<ul style="list-style-type: none"> current and future cost requirements cost reduction / avoidance continuous improvement 	<ul style="list-style-type: none"> Acquisition costs must be in line with that of most competitive negotiated status for corporate or government fleets. Devise system of benchmarking with data available through FMC's Measure acquisition cost as a percentage of manufacturer's invoice in order to track and compare vehicle discount rate Track current cost per mile and have OEM guarantee that the cost per mile will not exceed \$X.XX/mile Guarantee residual value of vehicle to the level committed to by OEM at point of acquisition or commit to components of service and quality in order to drive value proposition and contain costs (Based on agreed upon condition of vehicle). Year over year reduction in pricing of 8%-10% in year one, 5% to 7% in year two and 3% to 5% in year three Manufacturer's additional incentives will be offered to Merck in order to maximize available discounts (Benchmark best in class CPA & year end bonus information) Cost decision will be based on total lifecycle cost model
Innovation	<ul style="list-style-type: none"> New product and service plans and offerings Use of leading edge technology Ability to utilize market driven innovation 	<ul style="list-style-type: none"> Supplier needs to have clear plan and pipelines for implementing newer technologies in the near future Merck receives compensation in the form of discounts to participate materially in pilot programs, i.e., hybrid vehicles Explore available synergies with OEM suppliers in an effort to bring additional value opportunities to Merck

Exhibit 2

Options Summary Chart: Top 6

Options Summary Chart: Top 6 (■=1/ ■=3/ ■=5)

Strategic Options	Value \$ (Good/ Moderate /Poor)	Difficulty (High/ Medium/ Low)	Risk (High/ Medium / Low)	Score	Comments & Discussion Points
Single manufacturer agreement for all fleet vehicle needs for all of the Western hemisphere	■	■	■	3	Currently: The US and Puerto Rico utilize Ford; Canada, Brazil and ½ of Mexico Utilize GM. With full internal alignment in the western hemisphere, greater opportunities exist
Western hemisphere single agreement with inclusion of future peripheral options	■	■	■	5	Options: Utilization of scooters, metro cars, strategically placed storage containers and vehicle share programs all still in scope
Single manufacturer agreement by region, for all fleet vehicle needs in the western hemisphere	■	■	■	5	This scenario would create no additional leverage but might eliminate numerous one off buys in certain regions, creating slightly improved regional opportunities
Implement an allowance program (monthly or lump sum)	■	■	■	11	Major policy issues will arise. Image could be at stake if tight parameters are not formally legislated and implemented
Reimburse drivers on mileage instead of giving them company paid vehicles	■	■	■	13	As above, major policy issues will arise around company image. Also, there could arise a fair and equitable scenario based on what the rep perceives is being taken away.
Executive vehicle added to a sole source manufacturer	■	■	■	11	The fleet team does not feel comfortable legislating from which OEM the executives should buy their vehicles

Exhibit 3 Final Vehicle Options

OEM	Model	Status	Reason	Further review
Ford	Fusion		Not available until Q-1, 2006	
	500		Fits business requirements.	Price may be too high.
GM	Impala		Fits business requirements.	Awaiting crash tests
	Malibu		Further review of published safety data required.	Added torso side air bags.
DaimlerChrysler	300		Fits business requirements.	Operating costs may be higher
	Stratus		Further review of published safety data required.	
Honda	Accord		Availability; size; price	Research specifications
Nissan	Maxima		Fits business requirements.	Reliability data needs further review
	Altima		Further review of published safety data required.	Operating cost may be higher
Mitsubishi	Galant		Further review of published safety data required.	
Toyota	Camry		Size & price may not meet specified needs.	Research specifications
VAG	Passat		Size & price may not meet specified needs.	Research specifications

Exhibit 4

Excerpts from the Fleet Financial Cover Story, January-February 2007

Supplier Value Management (SVM) is a program that Merck implemented with selected suppliers to cultivate the supplier relationship for continuous improvement and value-add. SVM takes the sourcing process to the next level. SVM is a process of establishing and optimizing the delivery of value from a supplier relationship. Operationally, Merck measures the supplier's performance to ensure that its business requirements are met and that there is continuous improvement. Strategically, it ensures that business values are aligned and that there is collaboration between the firm and the suppliers to yield greater value. Pricing, and service levels are definitely part of the decision process; however, the expectations and deliverables aren't just developed by Merck alone; the vendors are involved in the process as well. Further, they then become part of both the implementation and ongoing application of the programs they themselves have been involved in developing.

The benefits of SVM to the suppliers go beyond, to some extent, the specific relationship with Merck. Bringing suppliers into the process as stakeholders, and encouraging them to contribute to the success of the endeavor, unleashes the creative process, which they can then apply to the marketplace in general. SVM helps to build the relationship beyond 'you sell, I'll buy', and into a true team environment, where ideas are exchanged, and both sides offer their input on how the process can be made better. For example, during the quarterly meetings, the teams discuss more than just the vendor's performance; they talk about the industry in general, new technologies and industry trends. Doing so can often bring to light how these trends can be nurtured in Merck's own relationship.

Procurement holds executive steering committee meetings with Merck's strategic suppliers, typically on an annual basis. Senior executives from both sides attend these meetings, and there is open sharing of business performance, objectives, and resources to ensure that the supplier is performing to and/or beyond the company's expectations and that projects are executed as planned. Additionally, this gives the executives opportunities to benchmark practices outside of the normal buyer/seller relationship and expand the value of the commercial interaction between the two companies.