LOW COST EQUIPMENT SOURCING:

Strategies for Driving Costs Out of Capital Equipment Purchases

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EXECUTIVE SUMMARY

A growing number of leading research and manufacturing organizations are adopting cost cutting strategies which drive costs out of their capital equipment budgets. Under this strategy, they attempt to purchase from alternative sources of equipment supply – including internal redeployment, the secondhand market and overseas suppliers – before buying new equipment from the customary original equipment manufacturers (OEMs).

Low cost equipment sourcing strategies deliver significant benefits. Many companies have found through using these alternative sources they can save 25% to 75% off the cost of new equipment. Not only does this save cash but it also improves their cost structure by reducing depreciation, making them more cost-competitive year after year.

It also allows them to pursue projects that would not otherwise have been economically feasible, and gets those projects up and running more quickly.

This paper outlines the best practices and lessons for low cost sourcing, based on our work with 50+ brand name global manufacturers and thousands of small-to-midsize research and manufacturing organizations.

OPPORTUNITY OVERVIEW

Companies today are under constant pressure to cut costs and conserve cash. As previous budgets are reviewed and upcoming years are planned, purchasing leaders report that yet again, they are being asked to do more with less. Having already made many of the obvious cuts, they are now looking for more efficient ideas to reduce costs – without cutting into core operations.

As companies have slashed costs and adopted lean techniques over the past two decades, the capital budget has so far remained relatively unscathed. Most companies buy equipment today similar to how they did 20 years ago – preparing an annual budget, reviewing and approving individual projects throughout the year and buying equipment directly from the traditional OEMs. While they have made some improvements by applying professional purchasing practices and standardizing OEMs, such savings have been incremental. Few companies have seen the need to radically rethink the way they purchase equipment.

Companies need to keep in mind that efficient purchasing tactics do evolve.

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In particular, three trends have created new opportunities for capital budget savings:

- **The Internet** – Low cost sourcing opportunities arise from a wide variety of smaller supply sources in various locations around the globe.

  Previously, companies were not aware of these sources – or could not take advantage of them – because they simply did not have access to the information. The consistent growth of the internet has changed such circumstances. Today, web-based databases, online marketplaces and search engines provide buyers with instant access to information worldwide.

- **Globalization** – Globalization has been the primary force creating new sources of supply. As a direct result of globalization, new equipment manufacturers have emerged in countries such as India and China. These overseas suppliers are producing increasingly higher quality equipment for extremely competitive prices.

  At the same time, globalization has also caused end user companies to radically restructure their manufacturing footprints. In turn, this has indirectly led to new sources of supply in the form of high quality surplus assets both inside the company and on the second-hand market.

- **Outsourcing** – Taking advantage of low cost sourcing opportunities requires focus, specialized knowledge and commitment. As companies have become leaner, many have simply lacked the resources to pursue low cost sourcing on their own. However, with the growth and increasing acceptance of outsourcing, companies can now engage specialized third-parties to assist with low cost sourcing initiatives. A good outsourcing partner offers specialized knowledge, market access and economies of scale which can significantly improve the effectiveness of these initiatives. At the same time they can improve efficiency by offering turnkey solutions, including dedicated resources, automated systems, etc., which save time and effort for the company. In this way, a good outsourcing partner can make it possible and advantageous for companies to benefit from a cost-cutting strategy they could not otherwise pursue. In response to these trends, a growing number of leading companies have begun adopting low cost sourcing strategies as a formal part of their capital procurement programs.

LOW COST SOURCES: WHERE TO FIND SAVINGS

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OPPORTUNITIES

Low cost sourcing programs are built on a simple premise: where possible, the company should source equipment from the lowest cost source of supply. But what are these sources?

Broadly speaking, best-in-class companies are looking to four sources of supply for their capital assets:

1. First, they look **inside the company** for surplus equipment they can redeploy internally.
2. Second, they look on the **second-hand equipment market** for opportunities to high-quality equipment that is surplus to the needs of their industry peers.
3. Third, they consider equipment offered by **overseas suppliers** in countries such as India and China.
4. Fourth, if they are not successful in any of the above channels, they purchase from **traditional OEMs**.

While these sources all fit together as part of the low cost sourcing model, they are separate disciplines. Each source has its pros and cons, and each requires a separate specialized approach to pursue.

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Looking Inside the Company: Redeployment

When sourcing capital equipment, the very first place that a company should look is inside its own facilities. By redeploying surplus equipment it already owns, the company can avoid the need for a new equipment purchase altogether.

Benefits of Redeployment

Redeployment is the most beneficial of the low cost sources:

- **It offers the greatest savings of any of the low cost sources.** Except for some transaction costs (e.g., transportation), redeployed equipment is essentially free and requires no cash expense.
- **It is easier to get buy-in on redeployment than on other low cost sources.** Since the company already owns the equipment, users know the equipment's background and condition, and have greater trust that the equipment will meet their needs.
- **It offers other financial benefits.** By putting nonproductive assets back into productive use, redeployment helps companies improve return on assets and strengthen their balance sheet.

Challenges of Redeployment

Despite its many benefits, redeployment may present some challenges:

- **Companies may lack visibility of their surplus assets.** Surplus equipment is rarely a priority for sites. Typically, sites move surplus assets out of the way into closets, storage rooms and other areas where it is soon forgotten. Sites rarely capture or publish an accurate surplus asset inventory list, either because they do not have the time or they may feel they could need the equipment some day. As a result, most companies have little to no visibility into their surplus asset population.
- **Internal customers may lack awareness of available assets.** Even when companies have an accurate and comprehensive surplus asset database, they often miss the majority of redeployment opportunities. This happens because the people who are actually making equipment sourcing choices are not aware of the information, or if they are, the information does not come through in a way that is compelling enough to them.

- **Companies may lack sound governance around redeployment.** There are many times when decision makers are aware of redeployment opportunities, but the redeployments fall through due to company policies. In some cases, the rules for redeployment aren't clear, resulting in lengthy delays or outright stalling of the transfer approval process. In other cases, the company's rules actually undermine redeployment activity. For example, accounting rules on the transfer of book value can create significant barriers to redeployment by financially penalizing sites when they try to do the right thing for the company.
- **Only a small percentage of procurement needs can be fulfilled through redeployment.** On average, global manufacturers are able to fill only about 2% to 5% of their annual capital procurement needs through redeployment. This is not to say that redeployment isn't worthwhile – the savings are so large even a 2% success rate can translate into tens of millions of dollars in annual savings.

Strategies for Success

The best way for companies to maximize the benefits of redeployment and minimize the challenges of redeployment is to have a formal redeployment program. At a minimum, this program should include formal processes and a centralized tool for tracking surplus assets. In addition, the program should be structured and administered in a way that ensures that the right people know about and are able to use surplus asset information when making sourcing decisions. Finally, the program should be professionally managed with metrics in place to measure key performance indicators.

Setting up such a program with internal resources can be a challenge. Most companies do not have the experience, knowledge or resources needed to build a robust and successful redeployment program. For this reason, the vast majority of companies that have set up formal redeployment programs have done so with the help of an outsourced partner.

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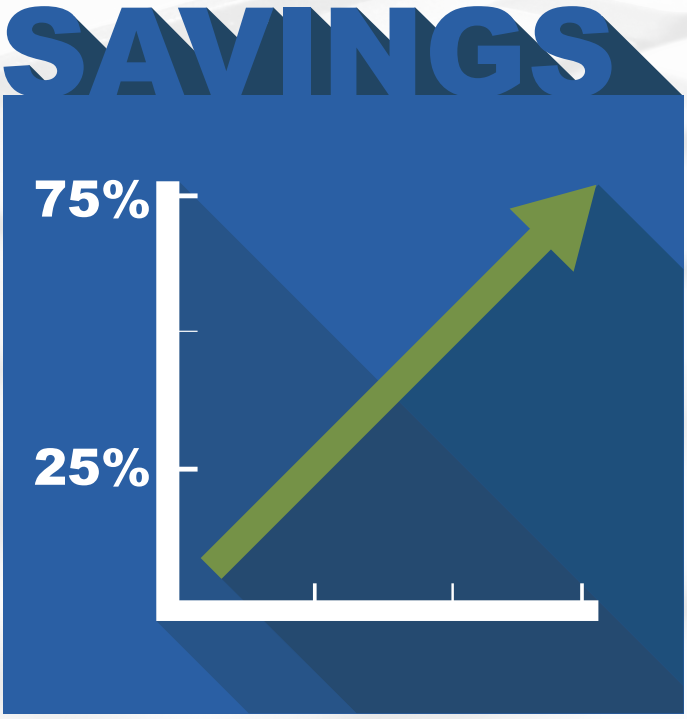
Looking To Industry Peers: Pre-Owned Equipment

Until recently, most large companies would never consider buying secondhand equipment. The used equipment market was limited to smaller, more cost-conscious companies, such as startups and contract manufacturers, who simply could not afford to buy new. However, today's secondhand equipment market bears little resemblance to the old image of run-down, outdated machinery rusting in a storage room.

In recent years, changes such as supply chain restructuring, mergers and acquisitions, plant closures, lean manufacturing and technology upgrades have unleashed an unprecedented wave of premium, pre-owned equipment supply. Today, companies can readily find top quality, late model equipment coming available from name brand global manufacturers. In fact, it is not uncommon to find equipment that is brand new, unused and still in the crate from the OEM.

By tapping into this source, companies can buy essentially the same equipment they would have purchased new – **at a 25% to 75% discount**. With such compelling value, it is no wonder that even the most reputable of companies are now building secondhand procurement into their formal procurement strategies.



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Benefits of Pre-Owned Procurement

It offers significant cost savings. Top quality, pre-owned equipment can typically be purchased for a 25% to 75% savings versus the price of equivalent new assets.

It is available immediately. When companies buy new assets, they typically have to wait for months before taking delivery due to OEM lead times. By contrast, most secondhand equipment is available immediately. This means companies can get their projects up and running faster – increasing the speed to market and/or reducing production downtime.

There is a much wider selection available than for redeployment. When searching for redeployments, companies have only one source: their own organization. By contrast, the secondhand market typically offers selection from their industry peers, from upstream and downstream producers and from other industries using similar types of equipment.

Moreover, the secondhand market offers equipment available both directly from end users and from dealers, brokers, auctioneers and other resellers. Thus, the secondhand market offers a far better selection – which translates into a far greater likelihood of fulfilling a specific equipment need.

Challenges of Sourcing Pre-Owned Equipment

While pre-owned equipment offers compelling benefits, it also presents its own challenges:

The pre-owned market is highly fragmented. Perhaps the biggest challenge that companies face is that they don't know where to start.

Because there are so many different sources of potential supply, it can be very time- and resource- intensive to try to find equipment. Because of this, many companies are only able to search within a very limited scope, or just throw up their hands and do not search at all.

Many internal users still resist the idea of used equipment. Another challenge companies encounter is continued internal resistance to the idea of buying used equipment. To get buy-in, companies must not only demonstrate the savings, but they must also educate and build trust.

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The pre-owned market does not work the same way as the market for new equipment. A third challenge for companies is the inability to utilize the used equipment market. There are several major differences between the pre-owned equipment market and the market for new equipment:

Pre-owned assets are one-shot opportunities. When companies buy new equipment, they know that the OEM will build a new unit if they do not have the equipment in stock. By contrast, there is only one of each pre-owned asset. If someone else buys it, the opportunity is gone.

Some pre-owned assets require on-the-spot decisions. When companies buy new equipment, they typically go through a lengthy capital approval process. On the other hand, some secondhand channels such as auctions do not allow buyers the luxury of time. The schedule is set by the seller, and the asset is sold whether or not the prospective buyer is ready.

Pre-owned assets are cash-in-advance purchases. Most companies are used to buying new equipment on terms – they issue a purchase order, receive the equipment and pay after a set period of time. In comparison, most secondhand equipment sellers require cash in advance.

As discussed below, these differences may seem daunting, but they can be overcome by the right low cost sourcing program.

Strategies for Success

In spite of the challenges, it is possible to successfully implement a pre-owned equipment sourcing program. The most successful programs have several elements in common. These include:

- **Making sourcing pre-owned equipment a formal process.** Because it is likely to meet resistance, the best way to ensure internal users consider secondhand alternatives is to require them to do so. This can be done by integrating pre-owned procurement into multiple phases of the capital budgeting, approval and procurement process.
- **Making sourcing pre-owned equipment easy for their people.** Another way to overcome resistance is to make the process so simple that it actually saves time. For example, an outsourced supplier can do most of the searching labor, pre-qualify assets to help minimize time spent internally on research and evaluate dead-end opportunities.

• **Creating clear governance and policies which support pre-owned procurement.** Because the used equipment market functions differently from new procurement, successful companies review their internal practices and develop strategies to adapt. In some cases, this means targeting specific procurement channels which are friendlier to their capital approval process.

In other cases, this means adapting their internal practices – or developing creative new practices – that allow them to be more nimble in pursuing secondhand procurement opportunities.

• **Formally managing change.** Successful pre-owned procurement programs are continually reinforced by an internal public relations program which publicizes success stories. Such programs also work to continually build awareness, educate users about opportunities and options, and build trust in the process.
Because most companies lack the time, resources, knowledge or experience to build a successful pre-owned equipment sourcing program internally, this area is also another excellent candidate for outsourcing.

Looking Globally: Overseas Suppliers

The third area of low cost sourcing opportunities is overseas suppliers. Over the past decade, equipment manufacturers in countries such as India and China have garnered growing attention for their products. Some of these companies are byproducts of globalization; they simply did not exist ten years ago. Others have longer histories, but have until recently been regarded as suppliers only to their local markets.

For years, global equipment buyers have regarded such overseas suppliers with suspicion. In particular, buyers have expressed concern about the level of quality and the level of support these suppliers could offer. These are still valid concerns, as many overseas manufacturers have not yet demonstrated that they can consistently meet global quality standards. However, a small but growing number of these suppliers are breaking out and starting to gain a grasp in the global market.

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Benefits of Overseas Suppliers

New Equipment for Significantly Lower Prices. Unlike redeployment and secondhand sourcing, overseas suppliers provide brand new equipment for substantial savings.

Similar Buying Process to Traditional/New. Again, unlike redeployment or secondhand sourcing, the overseas supply market operates essentially the same way as traditional OEM's – allowing for standard capital approvals, payment on terms, etc.

Built to Spec. A third benefit of low cost suppliers is that it is easier for them to build to specification. With redeployed equipment or secondhand equipment, the available options are often close to, but not exactly, what the buyer is looking for. This requires some tradeoffs. By contrast, overseas suppliers can typically deliver equipment built to an exact specification.

Challenges of Overseas Suppliers

Lack of Track Record. Many overseas suppliers are newer companies and/or lack experience in global markets. It is difficult to evaluate their performance or likely levels of support, because there is not enough data.

Hard to Find. Many overseas suppliers do not have well-established marketing or sales channels in global markets. As a result, it can be difficult to identify who the major players are, and which are reliable sources of potential supply.

Internal Resistance. Just as with second-hand equipment, companies often find they face stiff internal resistance to the idea of sourcing from unfamiliar overseas sources instead of trusted long-term suppliers.

Strategies for Success

In sourcing from overseas suppliers, companies need to do their due diligence. Usually this means making the investment in either having their own internal resource – or a consultant/outsourcing partner – invest the time required to learn the market.

Companies should allow for a more extensive due diligence process when evaluating overseas suppliers, allowing for extensive reference checking, quality testing, etc. in order to build trust in the quality. Companies should also pay close attention to service requirements, and should establish clear service level agreements in their supply contracts.

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A Second Look: Traditional OEMs

The final step of the low cost sourcing process is the traditional OEMs. At least for the moment, traditional OEMs are likely to remain an important part of most companies' capital equipment supply chains. However, even though they may fulfill the vast majority of the company's purchases, traditional OEM's should always be the last step in the process.

CONCLUSION: THE LOW-COST SOURCING MODEL

Again, low cost sourcing programs are built on the premise that where possible, the company should source equipment from the lowest cost source of supply. To achieve this, best-in-class companies approach procurement projects by systematically working through the potential sources of supply, prioritizing those sources which can deliver the biggest savings. They thus end up utilizing a four-stage process, which again is:

1. First, they look **inside the company** for surplus equipment they can redeploy internally.
2. Second, they look on the **second-hand equipment market** for opportunities to high-quality equipment that is surplus to the needs of their industry peers.
3. Third, they consider equipment offered by **overseas suppliers** in countries such as India and China.
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By starting with the channels that promise the highest savings, and ending with the more comfortable (but lower savings) channels, companies maximize the likelihood that they will find alternative sources of supply. It is important to approach low cost sourcing with realistic expectations. The vast majority of equipment purchases will still be fulfilled by traditional OEM's. However, because the savings are so significant when this strategy is successful – ranging from 25% to 75% savings for pre-owned equipment, to virtually 100% savings on redeployments – companies can save potentially tens of millions of dollars per year, even if they are only successful in a fraction of their purchases. Low cost sourcing is not without its challenges. Each of the channels requires formal processes, special knowledge, dedicated resources, and a change management effort.

Many companies lack the time or resources that would be required to establish a successful program. For this reason, the majority of companies that are succeeding in this area are doing so by partnering with an outsourced services provider. By outsourcing, companies can realize the benefits such as saving cash, reducing costs, and increasing their speed to market – while saving time and effort for their internal resources, and maximizing the likelihood of their program's success.

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