Part 1: Cost reduction or value creation – lessons learned at IKEA

Should the purchasing function reduce costs or create value? This is a recurrent and often oversimplified ‘fashion topic’, sometimes with claims that that it is ‘better’ or ‘more modern’ to create value than to reduce costs. However, what does the reality teach us? I will use a model to illustrate five different ways of sourcing.

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<th>Level</th>
<th>Products with no impact on the company’s competitiveness</th>
<th>Products with moderate impact</th>
<th>High impact products or category of products</th>
<th>Control product specifications: high impact</th>
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<td>Lowest unit cost</td>
<td>Lowest total cost</td>
<td>Optimise value</td>
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**Level 1** contains products with no impact on the company’s competitiveness. Such products are often low value consumables, like office material or toilet paper, but it can also be items for production or customers. The overall purchasing goals is to avoid cost for shortages by securing the basics e.g. quality, availability and brand protection with code of conduct and sustainability.

**Level 2** are products with a moderate impact on the company and now we can see a traditional purchasing behavior with cost analysis, new suppliers and competition. The goal is to achieve lowest unit costs. Level 2 is still the dominant way of sourcing in retail and is frequent in other industries. A typical result of this level is that the company has a fragmented supplier base.

**Level 3** is suitable for high value products or category of products. This is the first level of category sourcing, i.e. where the company bundles volumes of similar products to large volume packages. The focus now shifts from lowest unit cost to total cost and we can see global tenders that consolidates the supplier base, often quite dramatically. Example: IKEA had in level two 2,500 suppliers and a retail sale of 5 billion €, and now, with the majority of categories between level three to five, less than 900 suppliers are needed for a retail sale of 35 billion €.

**Level 4**. Important products/categories where the company controls the product design and specification. In retail, these are the private label products. Now purchasing and suppliers are earlier and deeper involved in new product development. Although cost reductions still are essential, more and more value is created by new solutions with better customer benefits.

**Level 5** is the products that steers the company’s competitiveness and position on the market. Now it is not good enough just to optimize value but the company need to invent and innovate products, technology and critical activities throughout the value chain. The supplier base is designed and we can see more in-house production. An example of products in level 5 from IKEA could be the LACK table which is retailed at around 5 €, sold in the millions and cheaper than a pizza.
Another perspective of purchasing levels is how value is created. At each level the created value grows, but in different ways. The cost reduction (light blue in below model) increases in each level but gradually we can see a higher share coming from improved customer benefits (dark blue).

For each step there is a gain of 5-15% depending on the commodity and company. Raw materials and standardized commodities have the lowest results and designed products the highest.

Example from IKEA: Sven-Olof Kulldorff, Ikea’s purchasing manager from 1995 to 2004, states that price reductions during that period exceeded 35 per cent, and the former CEO Anders Dahlvig writes that purchasing prices were reduced by 20 per cent between 1999 and 2009. These time frames overlap, and not all the savings are the result of category sourcing; however, it’s clear that Ikea’s efforts in developing sourcing have been worthwhile.

Cost reductions are not the only reason to develop from one level to the next. The way of working influences – and is influenced by – how the company views its supplier relationships. This includes the development of products and technology, improvement activities with quality and distribution, and creating conditions for ecologically sustainable sourcing. To sum up, strategic development into a new level represents a major change in what you do, how you do it and who you do it with.

Now to the core question: is level 5 better than level 1? Not at all. The level of sourcing need to be in harmony with the products impact on the company’s competitiveness. It is not enough only to reduce costs on products where the company controls the design, and it would be ridiculous (if you are not a pen manufacturer) to spend resources to innovate the value chain on pens.

In the next article I will describe the levers and strategic activities on level three and four, i.e. category management and private label.

Different opinions, improvement suggestions and questions are very welcome in the comments or directly to: magnus.carlsson@helkin.se

Magnus