December 2015 – Article - What’s the Total Cost of Ownership?

Total Cost of Ownership, TCO, is not a new concept.  It’s basically a mapping, identifying, calculating and taking into consideration all costs involved in a project, in an acquisition of something, yeah?  It can be a material, a service, a production line, whatever you buy is not purely taken into consideration the acquisition cost as sometimes some companies do when procurement for example go to the market to run RFP for a new product.

But instead of that, it’s actually taking acquisition cost and adding all various, different costs for example, inventory carrying cost, obsolescence, transportation cost in terms of if you are transporting it by air often because your supplier is far away on your production site, that should be taken in consideration as well.  The cost that you lose or the opportunity cost when you don’t sell your product and that goes over in and out so there are different levels of sophistication.

An example of TCO.

I like being simple.  One of the best and very simple examples I have is buying a car, yeah?  Buying a car.  When you buy a car, you can buy purely based on the cost that you find in the dealer which is the acquisition cost which is one way of buying a car.  But the TCO applied to that scenario would be to buy the car based on the lifecycle of that car, so it would be the car, the cost of insurance, the maintenance, the fuel consumption and all the different elements that you, all the different cost elements that you carry over the life of your car.

That can be very easily extrapolated to production line and then to a material that your company buys or to a packaging or to service your company buys.  But the car example is one of the easiest ones to make it happen.  I think some time in life, each of us have a bought a car or you a buy a car or have seen anyone buying a car, yeah?  That’s why I always use this example.

Why TCO is so important.

Well I think it comes back a little bit back to question one.  It’s Total Cost of Ownership so you get full visibility of the hidden cost.  Think about an imagery of an iceberg, when you buy only based on the acquisition cost, you’re only seeing the top of the iceberg outside the sea.  Underneath, you see there are many different costs, very important costs, sometimes even bigger than the top of the iceberg that are hidden and not necessarily considered on a structure base and not often bases has a decision-making to.

And again, those costs can be cause of obsolescence, insurance, extra freight [ph] when you send your goods via air rather than the traditional ocean or road.  Cost of losing the sale, pillage and so forth.  It can go well beyond in terms of sophistication.

How those TCO uncover hidden cost?

It’s quite simple.  You need to identify, look at what you buy.  Identify what are the flow and the network of source, where you buy, how often do you buy, what’s your MOQ, the minimum order quantity, MBQ, minimum batch quantities, what are the lead times, what are the logistics, the inbound and outbound, the logistics for new suppliers for your site.  And then once you identified that, then you create the visibility to a clearer picture than that and then you start to calculate on the various different elements of the cost.

It doesn’t need to be precisely right, yet it can’t be precisely wrong, necessarily wrong.  The idea is to have a good idea, a good estimate of all those different elements so by then, we finally work with the various teams and the supplier and internally, for example, finance is a typical team that works together with procurement and supply chain while developing TCO appropriate.

What else TCO can tell you.

Once you’ve done that, once you identify your network and your flow as a consequence, total cost of ownership will clearly show you which are the inefficiencies that you have in your supply chain or in your chain through, from your supplier to your own site or to your third party.  That can go all around high inventory levels, bad service levels, your own lead times, obsolescence, wrong placement of the supplier, wrong type of supplier and so forth.

How to implement TCO in practice.

I’ve been doing this for quite a while, yeah, and then as most of the things in life, there’s not always one size fits all approach.  My recommendation based on the rework experiences just started small. I worked with a multifunctional team, get people onboard, be flexible in terms of how you model your TCO.  Build a VCO version 0 spreadsheet and be flexible to evolve and take in perspective and in consideration different ways of mapping or calculating your total cost.

Typically, the key areas here are definitely [ph] procurement and planning but also finance and sometimes logistics.  Focus on the ones, if you have your model, you have your team, you have the buying and then you need to start small, then I like to start to three main different streams.  One is to fix existing problems so put together a list of top offenders and then that can be done very quantitatively so we try to, once you’re carrying high inventories, you’re losing sales in terms of bear to that service, higher costs and so forth so that’s the top offenders and that has a more fixing approach.

Then the second element I like to look at is new negotiations, new RFPs wherever you run a new RFP, then it’s quite worthwhile to bring TCO new decision variable to decide out of the RFP, who are going to be your suppliers so that it’s more presentable so it’s avoiding to create new problems in your chain.  And then similarly to that, it’s a new product plan, number three is new product launch whenever you launch new products, new innovation products, it also uses TCO as the decision-making variable to decide where you buy the elements, the components of your product in total perspective or total cost ownership way.

How to start running a TCO program.

I think here, you need to first create this case, the business case for the change and then quite easily comes from identifying very bad scenario of poor service and the inventory and then can be hopefully not on an end to end view of the business or throughout your business, but it can be quite easily in that proper category or a specific factory or a specific portfolio of products.  Manufacture internally or even externally.

I like always to look at the approach from a top-down perspective being recommended or mandated by these new leaders but also building the program from bottom up, having people, the key stakeholder’s information a few times playing in procurement, finance, logistics, well-engaged in the program, well aware what each one of them and what are the contributions.  I think the combination of top-down and bottom up works fine, works quite well.

And then again, implementing not throughout the business, but really try to be selective [ph] in terms as where to implement, where are the most considerable low hanging fruits which will deliver a robust pilot and these robust pilots then can build the credibility to be the void [ph] across the business wherever it make sense and then demonstrate success and deploy it for them.

How to overcome resistance.

I think that’s a good point.  Usually, you get some pushback from, as always, you go to a change process in any case.  I think in terms of TCO, resistance can come from few angles, so one is procurement.  Who quite wrongly sometimes, these are measured, performance by, through a simple and single view of acquisition cost.  It’s the typical how I can get the lowest possible acquisition cost.  But then once that’s implemented, then you get extra cost, hidden cost of the TCO you identified.

Really, to overcome that resistances, you need to work with procurement quite closely.  And to show the business and that’s not only procurement to show the whole business worth and the size of the price, say what’s the pertinent size if we move from TCO, from an acquisition cost to a TCO perspective for decision-making.  The other thing is in planning and supply chain planning, then the typical resistance here is they don’t have the time to provide the right variables or they are not very interested in thinking medium and long term.  They focus on the short-term view of things and that you need to show them how to overcome resistance, what’s in for them in terms of overcoming, avoiding future crises, getting a much better visibility and control of the supply chain, having their partners, their suppliers placed at the right location and serving them with the right lead times and the right minimum, maximum and variable batch.  Then also I think for that point is work with partners as an independent entity to calculate with credibility, what’s the real total cost of ownership and making the bridge between supply chain planning and procurement.  And then base decisions on facts, hard facts and how qualitative, quantitative and qualitative the variables.

Then it makes for the typical individuals involved in this environment supply chain and procurement when you talk numbers, when you talk facts, decisions are quite easily taking, the right decision is quite easy to take.  And then once all of that is done, then clearly, you need to ensure that the implementation is right and then need to prove a clear governance in terms of bringing that to life with clear targets for each of the parties involved and all part of the targets need to be cross-functionally [ph] aligned and also linked back to, career progression and et cetera.  That I think is a good way to overcome resistance.

And building a strong team, we have a transparency and not as then [ph] but we altogether as representing the business.  Thanks for that.  It has been a pleasure Dustin for having meeting you again.  I hope that helps you and your public.  By all means, reach me out if you need any help in terms of how to run TCO program in the future.  My contact details, you can find there, but it’s anyway, julio.franca@spinconsulting.net.

A little bit about myself, I am an engineer as a background.  I worked over 20 years in supply chain.  I run a company corps, a consulting niche boutique company called Spin Consulting.  We are very much focused on the short-term assignments, result measurable projects, working in the supply chain procurement logistics and all end to end business projects.  We can do of course strategy development but we are very hands-on operationally-oriented, so we work very close with our clients that you can find some of them in our website, www.spinconsulting.net where we work very closely then to get things done, get things implemented and again, get results in their PNL and balance sheet so that’s a bit about us.