Realize Economies of Scale & Growth – Centralize the Purchasing Function

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Doug Austin is the founder and President of StrategicSource, Inc., the leading provider of Spend Management Services (strategy, spend mapping, sourcing, process improvement and audit) for the automotive and truck dealerships, education, hospitality, service and manufacturing markets.

Doug has over 35 years of line, staff and executive management experience in Spend Management, Purchasing, and Supply Chain Management in various vertical markets including airline, retail, manufacturing and services.

Doug has been married to Peggy for 39 years, the father of three children and the grandfather of nine. Doug is a proud veteran of the U.S. Marine Corps, a graduate of the University of St. Thomas, and a speaker at various conferences and 20 Groups. Doug is also a trainer, consultant, and business owner.

Based on some of my early management experiences in airline and retail and continuing on today in our Spend Management practice, I believe that centralized management structures as it relates to staff functions such as HR, Purchasing, and IT perform better, more efficiently and more cost effectively than the decentralized organization structures that are common today in organizations that are growing through acquisitions.

I would also argue that organizations that are focused on growth, and the inherent "economies of scale" that come with well planned and executed growth and acquisitions are actually realizing "diseconomies of scale" if they operate with a decentralized management structure. Decentralized management structures by their very nature cede management control and authority to several managers in various locations. While the decentralized approach may be viewed as more in touch with local needs, the risks, inefficiencies and additional costs that come with decentralized management are eye opening if well understood.

Many successful organizations seek growth and scale…. with the expectation that the group will become more efficient, more profitable, and create a sustainable competitive advantage. I would argue however, that If that growth strategy is not aligned with the right management philosophy and the right management structure, the expected benefits from growth might turn into unexpected higher costs and new inefficiencies, contrary to the intended objectives.

Organizations on a growth trajectory or those that have already achieved those growth objectives expect that growth will provide the ability to do more, at less cost, driving new efficiencies, throwing off additional profit in the process and achieving competitive advantage.

While our business supports many types of organizations, large and small, profit and non-profit, I see countless examples of significant diseconomies of scale in growing, decentralized groups costing organizations hundreds of thousands and millions of dollars each year.

Auto Dealership Space

While retail in general is undergoing an upheaval with frequent store closings and bankruptcies, the Dealership space is undergoing consolidation through mergers and acquisitions. The pace in the dealership world doesn't appear to be slowing down. Large Dealership groups are buying single and dual point stores, large groups are buying other large groups and so on. The notion of consolidation makes sense to anyone with a rudimentary understanding of economics……. consolidation should bring economies of scale, less cost, more efficiency, more profits…. competitive advantage.

Economies of Scale – Expectations of Leadership

Executives driving growth through mergers and acquisitions expect to realize economies of scale across the organization that will be realized through the following new benefits:

- **Shared Business Functions** - Businesses or units share centralized functions
- **Staff Efficiencies** Fewer staff needed to support a larger organization
- **Purchasing Leverage** - Larger spend and leverage should reduce prices and costs
- **Specialization** - Larger size allows for more specialization in staff and functions reducing risk
- **Lower Capital Costs** - Improved cost of capital opportunities given larger asset base
- **Facility Consolidation –** Fewer or better sized facilities to house the organization
- **Knowledge / Data** – Greater efficiency can occur through improved data/knowledge
- **Cost Advantages** – New efficiencies, higher output, lower costs should provide cost advantages
- **Competitive Advantage** – All of the above listed benefits should provide competitive advantage over smaller, less efficient competition

Diseconomies of Scale - New Normal in Many Large Decentralized Groups

For organizations that operate in a decentralized environment and are growing, diseconomies of scale can occur from the following:

- **Duplicative Functions**- Rather than sharing a centralized function, functions are replicated throughout an organization, causing waste. This is often referred to as over-crowding…. too many people doing the same task and/or occupying a space that is physically too small for them.
- **Staff inefficiencies** – It is easy to reason that additional staff and management will be required to support duplicative functions.
- **Lack Purchasing Leverage** – Decentralized purchasing functions generate smaller purchases with more suppliers, sub-optimizing their leverage, realizing higher costs than are necessary and creating more for payables staff to pay more suppliers. A centralized Purchasing function will aggregate and leverage their unique spend position to maximize efficiencies and price.

- **Lack of Specialization**: Many Executives view many of their managers as "utility players" who can learn and play any position such as Human Resources, Purchasing, Information Technology, Safety and more. Managers who receive no formal training and little operational direction in their newly assumed responsibilities may have good intentions but can't generate results locally that an experienced resource could achieve in a centralized environment,
- **Facility Duplication–** A large group might operate with eighteen (18) Accounts Payable offices which is inherently less efficient than one central Accounts Payable location……using more space and labor than is required to pay suppliers, not to mention technology costs and other miscellaneous expenses.
- **Lack of Actionable Information** – While data has potential value, greater volumes of data doesn't add value if not mined, utilized or applied to the appropriate management challenges. As an example, if your centralized corporate office does not know how
- **Bias toward revenue** – Auto Groups are focused on top line sales. All problems can be addressed by selling more. Operational improvements are left to those further down the chain of command and often do not occur.
- **Decentralization** – the management philosophy allowing decentralized functions to exist is the primary contributor to diseconomies of scale
- **Management Fear/Indifference** – Growth brings change. Some management can see the economies of scale opportunities and will attack them. Others may see the opportunities, but may be afraid to act, or they may be "too busy" to act, or they may hope the problem will be addressed by someone else.

Realizing complete economies of scale across a growing organization can provide significant, sustainable profit improvement opportunities to an organization frequently providing millions of dollars in new benefits. The first step for executive management is to examine current profitability levels considering the organization structure. If the organization is decentralized, particularly the Purchasing, HR, and IT functions, then management needs to set new, challenging expectations and objectives to centralize those functions across the organization. Once centralization has occurred and is managed effectively, new efficiencies will occur which will be visible with new bottom line profitability, the ultimate objective driving growth to begin with.

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