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AN ALTERNATIVE VIEW OF THE REVERSE AUCTIONS

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In the July-August 2004 issue of "Gremi" magazine, Ricard Casals, the well known expert and a good friend, analysed the use of reverse auctions by various large clients in the graphics sector and describes this negotiation mechanism as perverse, finally concluding that "it is not advisable [for printers] to enter into the reverse auction game".

I believe that the reader will agree with me that burying your head in the sand is not usually the most effective tactic in the business environment. I am writing this not only to define, analyse or refute, if appropriate, the objections of the aforementioned article, but to put forward the causes of the inevitable spread of reverse auctions and how they may also be considered as an opportunity for the graphics sector.

In short, the objections of the electronic auction in the aforementioned article focus on the fact that the auction transforms what should be a graphics service into a commodity for which price is the single decision criterion, forcing prices lower and driving printers to make inappropriate offers. Furthermore, it does not serve the clients, because they use the lower offer from an unknown supplier to obtain a higher discount from their usual printer, causing the printer to accept lower profitability and placing the future of a good supplier at risk. Similarly, if the client awards the business to an unknown supplier, there is a cost to both parties of having to adapt to each other, with problems of quality, delivery, etc. which are usually necessary.

In order to be systematic, I have divided this article into three sections. The first is a general analysis of the strategic framework that we shall call "the new purchasing function" and the influence of technology on it. In the second section we will see the implications of the general framework on the client-graphics industry relationship. Finally, we will look at the reverse situation, where it is the graphics industry that interacts with its suppliers via the use of new technologies.

Electronic negotiation is here to stay

Have clients' purchasing departments changed so much in a relatively short period of time, that purchase auctions have become the norm, at least among certain types of clients? The answer is yes. Globalisation, corporate concentration and the spread of knowledge and technology have improved corporate productivity. In many sectors it is difficult to make advances in a company's production process; improvements must be found in other areas and in particular, in purchasing. The purchase function has become one of the principal areas for improvements and companies are pushing it to be a source of competitive advantage.

This strategic viewpoint of the purchasing function is underlined by a study made by the Spanish Association of Purchasing and Supply Managers, which states that a 1% cut in costs for a typical company has a 7.5% impact on profit. (The study is available from the association's website: <http://www.aerce.org/upload/articulos/5compras.pdf>).

The purchase auction is just another example of the influence of new technologies on corporate processes, which began with the sales process (e-commerce) and has gone on to encompass all corporate areas (e-business). E-learning, the employee's portal, e-marketing, e-purchasing and e-sourcing are all corporate activities that make up the concept of a network connected company and that represent e-business.

There is no doubt that bad practices have had their place at purchase auctions with bad outcomes for both suppliers and purchasers. However, despite this fact, companies that develop the technologies, consultants that organise purchasing events as well as the actual clients, have all learnt. Today the technology and methodology are guaranteed to really reduce costs when the necessary conditions are applied. It is a fact that if the auction delivers cost reductions, the purchaser will use it.

If we look at purchasing and procurement, we should distinguish between at least two types of solutions based on new technologies. There are those focused on the actual negotiation between purchaser and supplier, known as e-sourcing solutions and those designed to facilitate provisioning, making a catalogue available to the purchaser, called e-procurement solutions. Although it hasn't always been like this, we can consider that purchasing conditions are set via e-sourcing and the results obtained from the negotiation form part of the e-procurement system for facilitating future orders from purchasers or authorised users.

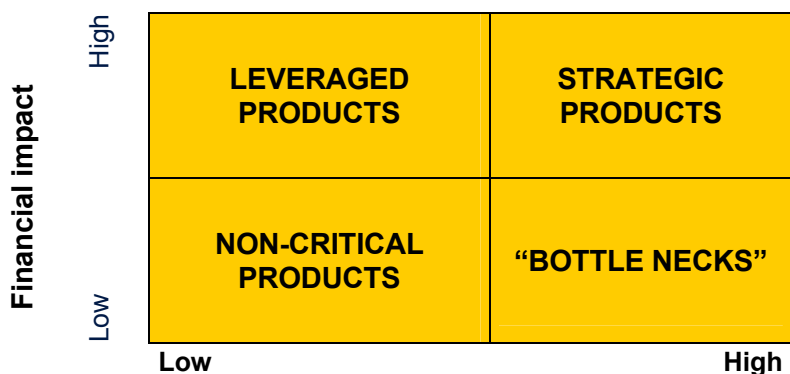


Fig. 1. Kraljic matrix

Electronic auctions are possibly one of the best known and most controversial tools for e-sourcing. However, there are other electronic business tools such as requests for quotations, proposals or information, better known by their RFQ, RFP and RFI abbreviations respectively. While the offers from some suppliers are unknown by the others in these latter tools and may include additional factors apart from price, the reverse auction is defined by real time competition, with price being the sole criterion.

We should ask ourselves what characteristics a negotiation should have to be suitable for an auction, under the sole consideration of price. Let's start with the Kraljic matrix (Harvard Business Review, 61, 1983) and the behavioural traits of the purchaser based on the quadrant applicable to the good or service to be purchased (figure 1). The Kraljic matrix forms the basis of current purchasing department strategies. The general recommendations would be as follows, depending on the risk/complexity and the financial impact of the purchase:

§ Strategic products: supplier alliances and development – long term.

- § Leveraged products: buy at the best price (spot purchases) – short term.
- § Non-critical products: improvement in administrative processes – automation.
- § “Bottle necks”: search for substitutes or new supply sources.

According to this analysis, the client’s response depends not so much on the supplier’s will, effort or level of availability as on the matrix-location of the purchaser’s need. All suppliers on the left of the matrix are threatened, with the threat increasing higher in the matrix. The only possible strategy for a supplier in the top left hand corner of the matrix must be as a cost leader.

Nearly all current e-sourcing solutions incorporate different negotiation methods based on the specific requirement.

Returning to the reverse auction, we already have sufficient experience to be able to draw some conclusions:

§ The success of an auction, in terms of the savings obtained by the purchaser, depends on two key factors: the ability to define the good with clear and unambiguous specifications (“high specifiability”) and a market with supply-side liquidity where there are plentiful suppliers that compete among each other to get the business (“highly competitive”).

§ Empirically, there is a direct relationship between the order amount and the savings achieved, with larger volumes achieving greater percentage savings. It is therefore preferable for the purchaser to plan and pool requirements together for a specific period of time and to auction its business together, rather than use various auctions.

§ Only suppliers known and approved by the client should be invited to participate in an auction, so that they compete under equal terms. The rules for awarding the contract must be clear from the start of the auction and the subsequent communication with suppliers should not take an unreasonable amount of time.

In conclusion, if a product can be perfectly defined, competition between suppliers is high and the value is sufficient, the better suited it will be to an online auction for the purchaser. Experience shows that substantial savings can be made and the risk that the purchaser incurs is minimised if the auction is carried out between approved suppliers.

Although to date, the use of electronic negotiation or e-sourcing has been limited, focused around large companies and contracts, using organised auctions and organised by specialist consultants, the current trend is towards a wider use of technology tools and the ability of purchasers to operate independently without the need for a third party. This trend will bring many negotiations onto the internet although not necessarily in the form of a reverse auction.

Electronic negotiation between clients and the printer

If we apply the above to the graphics market, the resulting outcome is discouraging for many printers; they will often find themselves in the leveraged product area of their clients' Kraljic matrix.

Furthermore, the conditions of specifiability and competition that are required for a negotiation via reverse auction usually exist.

§ Many clients are capable of providing the printer with a perfectly detailed specification.

§ Many graphics products have clear and relatively simple descriptions.

§ Printers approved by each client usually have similar machinery and technical capabilities.

§ Competition in the sector is enormous with clear excess production capacity, especially in Catalonia.

§ This is also the case when the client's graphics product is strategic, for example publishers, yet the conditions of high specifiability and high level of competition are still applied.

On reflection, we realise that, independent of the technologies, these are the circumstances that have driven down prices substantially in recent years, compromising the future of many printers. Electronic auctions simply take advantage of these circumstances for the logical benefit of the purchaser; but they haven't created these circumstances and avoiding auctions will not change them in the short term.

When a specific graphics product appears in the upper left quadrant of a client's Kraljic matrix analysis, it is very difficult to convince the client that this is really a service with added value, even though we can demonstrate that the value exists and furthermore quantify it. For a general manager of a client company, 50,000 copies of a colour DIN A4 brochure with 16 pages on 150g/m² coated paper is nothing more than that. Quality, delivery on time and good service are prerequisites, not added value.

Although tough for the supplier, the auction is fair and has the added advantage of transparency. The outcome entails obligations not only for the supplier, but for the client as well. Here is some useful and simple advice when invited to an auction:

§ Insist that the rules be clear from the start. For example, will the printer with the best offer win the contract or is it open to the client's discretion?

§ Keep hard copies of the published conditions and specifications as well as any questions raised, since you may not have subsequent access to the auction environment.

§ Do not hesitate to state any doubts or minor questions prior to the auction being held. Ask if you should include samples and how many, if a representative from the purchaser has to be present prior to commencing printing, packaging or delivery conditions, payment methods and deadlines... Do not leave any aspect unspecified and do not hesitate to apply the cost of any concept that could have an impact!

§ If you have alternatives that benefit you or the client, state them clearly. Clients can always delay the auction or modify their terms and specifications so that they benefit you more.

§ The client must also comply rigorously with the auction's conditions. For example, if the conditions indicate that the client provides files in PDF format ready to be printed, insist on it.

§ Do not be afraid about charging extra for extra work or tasks.

§ If the purchaser shows any evasiveness, document it in an amicable but firm manner, with reference to the purchaser's own published specifications and conditions.

§ Ensure you know your costs and your margin. If you do not know your precise costs, make an initial offer and do not improve it (see the "green" supplier in figure 4). Decide your minimum profit limit in advance and above all, do not get carried away.

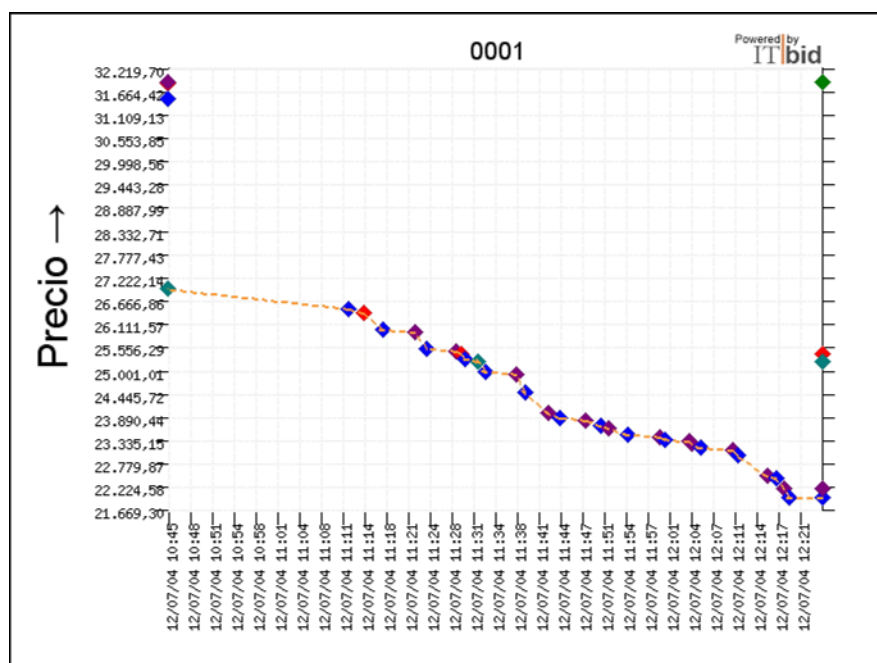


Fig 4. Graph showing the development of a real auction in which five suppliers participate to supply cases of boxboard to a pharmaceutical company.

Note the enormous difference between the initial and final offers of some of the suppliers and the fierce competition between two of them.

I agree with Ricard Casals in relation to his recommendations: printers must understand and seek to optimise their costs and to achieve a high degree of efficiency. Put simply, you must lead on cost (and not price!) for products considered as homogenous by the client or market.

Clearly, another strategy is specialisation, looking for niche markets where the competition is less and our abilities are specific and greater than the competition. The more specialised

suppliers become the fewer auctions they will be invited to participate in, although they will be invited to increasingly more negotiations via RFQ, which are less “aggressive” than the auction but are also a form electronic negotiation within e-sourcing.

Electronic negotiation opportunities in the graphics sector

So far we have seen the threats; now let’s look at the opportunities. The first one is obvious. Since the majority of e-sourcing systems allow suppliers to previously self-register, making initial contact with many large clients is much easier and brings savings in sales efforts. This does not automatically certify us as approved, but it does make our information available to the appropriate people. I would invite the reader to surf the internet searching the websites of large companies; you will discover that many of them make contact with potential suppliers very easy.

Let’s focus on the essential content of this section. If you have never done it before, it is worthwhile drawing a Kraljic matrix and positioning your requirements for various materials and products upon it. Figure 5 gives some examples.

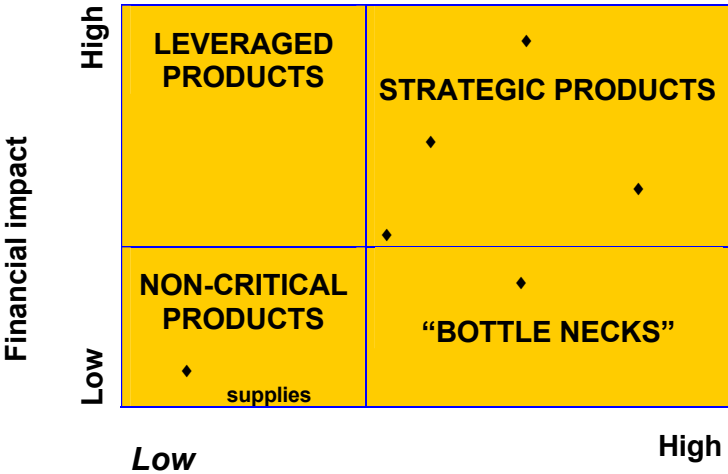


Fig. 5. Kraljic matrix applied to a graphics industry.

You, Mr Printer, buy paper. In fact you buy a lot of paper. Before making your order, and especially when the purchase is significant, you initiate a series of conversations with paper manufacturers and distributors. With few exceptions, there are three, four or more different manufacturers that can provide you with the paper you need, with highly similar characteristics and all the paper will comply with your client’s specifications: it’s an auctionable purchase!

In the most stable paper market conditions, perhaps even you could plan your medium term requirements to increase the value negotiated and to obtain better conditions. But, who wants the risk of a single supplier? No problem. Auction 65% of your purchases and award the remaining 35% to the second best supplier.

What applies for paper is equally applicable to inks or plates, and the total will very likely exceed 35% of your turnover. If you were to auction only 20% of your purchases, you could obtain a 2-3% saving on your total purchasing.

In general, the graphics sector has not given the attention it should to purchase negotiations. Graphics companies generally lack well defined purchase negotiation processes that can be followed methodically by the personnel responsible. Every day we see high value purchases negotiated by workers who are very reliable and technically skilled, but who do not have the necessary knowledge and abilities to optimise this process. Many manufacturers believe they are good negotiators and that they maintain excellent relationships with their suppliers, but our experience shows that this relationship is unequal and that printers also fail to define the objectives to be achieved from the relationship.

The introduction of electronic negotiation systems in a company begins to make up for these deficiencies, although only partially. They provide a uniform methodology that is based on best practices. They radically improve a process that is currently undocumented and they provide an excellent excuse to train the personnel responsible in the fundamentals of purchase negotiation. It is almost a reengineering of the purchasing process, but with low impact on personnel and giving results that can be quantified from day one.

There are various ways of initiating electronic negotiation. If your business has sales of three million euros, you should think about establishing it; if it has sales of five million, it is essential. The best solution for companies in the graphics sector is to “rent” the technology, where the provider of the e-sourcing solution supplies the software and the entire infrastructure; the printers and their suppliers simply require internet connected computers. There are excellent solutions available starting at €6,000 per year.

Another possibility is to pay for a “purchasing event” for a specific procurement action. In this case, the consultant company would be responsible for helping with the specifications and putting together the suppliers, through to the final act of the auction. Fees usually consist of a relatively small fixed component and a variable component based on the savings achieved, although it can be purely variable depending on the good to be negotiated.

Purchase events are only organised for large volumes—approximately €50,000 or more, depending on the consultant. They are applied to precise, high value purchases and are highly useful for non-standard negotiations, such as the construction of a new warehouse or the supply and setup of a complete network of computers in a company.

Another issue to highlight is the lack of group purchasing schemes in the graphics sector and which are so common in other lower economic impact sectors. This highlights the inappropriateness of the approach that printers are applying to their purchasing function. The fragmentation in the sector cannot be the reason for the lack of group schemes, since these are formed precisely to improve the acquisition processes and to increase the bargaining power with suppliers in fragmented sectors.

With a very lean structure, supported on new technologies, a group purchasing scheme in the graphics sector could manage the monthly (or appropriate frequency) negotiations of the principal products and could set the general purchasing conditions for its members. The normal practice in these schemes is to match the general conditions to the individual requirements between each member and the supplier. In the absence of other initiatives, perhaps the sector's guilds or associations should consider promoting or encouraging them.

Conclusions

- Whether you have or have not already participated in reverse auctions, this negotiation method is spreading very quickly among the clients of many companies that print books and brochures in general. Appropriate quality and excellent service might hold back the process for some specific clients, but there is a clear trend within the general framework towards a reduction in prices.
- Faced with this situation, commercially, printers must participate responsibly in the auctions to which they are invited. Insist on clear rules and specifications and reciprocity on the commitment from the client.
- Do not hesitate to lower your offer if you wish to get the order, but do not go below your pre-set limit.
- If printers cannot establish a strategy to gradually migrate to a more specialised niche, they must act decisively on productivity factors, including those on the production side and the more frequently overlooked, but no less important, supply costs. The latter can be handled quickly and highly profitably using e-sourcing solutions and its tools, which include the reverse auction.

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