



# BATTLING POWERFUL PROCUREMENT GROUPS

## *How To Profitably Participate in Reverse Auctions*

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The advent of online auctions in the mid-nineties cast fear in the minds of marketing and sales executives that already powerful procurement groups had found the ultimate weapon to drive down market prices. Indeed, this fear has some validity: according to a recent report by the Aberdeen Group (2003), online auctions led to an average price reduction of 13.2% when compared to traditional sourcing approaches. Like many Internet technologies, however, the hype surrounding reverse auctions may have been a bit overstated. Approximately 1,600 online marketplaces with the capacity to host reverse auctions have entered the market since 1999. However, most of those companies have since gone out of business with some analysts predicting that less than 300 will survive by 2005<sup>1</sup>.

Despite this trend toward lower usage, reverse auctions still account for over 5% of all purchases by large companies. If you have customers in the Fortune 2000, your chances are one in four of being asked to submit bids through a reverse auction process. In short, while reverse auctions are not as big of a threat as originally feared, they have become a regular part of the tactical play book used by some procurement groups to drive down prices. Even if you are not participating in them today, the odds are that you will be confronted with one in the near future. The likelihood of facing this purchasing tactic makes it critical to have a proactive

strategy for dealing with them when that day finally comes.

### **The Risk of Reverse Auctions**

Customers use reverse auctions for two purposes: 1) to purchase commodity goods at the most efficient possible price and 2) to tempt sellers of differentiated goods and services to give away their differentiation in the heat of the bidding. The first point represents the cold-hard reality for suppliers of commodity products. Without any real differentiation, the only basis for winning business is price, and auctions are an effective way to ensure that the market price is driven as low as possible.

For suppliers of differentiated products, the second objective conceals a hidden risk because by over-discounting their differentiation in an auction, they undermine their position in subsequent negotiations. This was a serious problem with one unwary supplier selling into General Motors Global Procurement Group. The supplier had participated in an online auction in one country but did not win the bid despite offering aggressive price discounts. Unfortunately for the supplier, its bid had been captured in GM's pricing data base and that low price was used against it when it submitted a bid in the U.S. market. As the example illustrates, participating in reverse auctions can have unintended consequences, making it critical to have a clearly defined strategy for participating and winning in a tough game.

## **A Strategic Approach to Reverse Auction Success**

The first step for engaging in reverse auctions is to set realistic goals for what can and can't be accomplished. Success should be defined as winning only those bids that are profitable and that do not undercut pricing on other products or accounts. Auctions are an effective tool for buyers to earn lower market prices. Consequently, it is unrealistic to expect to maintain current price levels or margins absent a significant cost advantage. A more realistic goal is to maintain volume for your commodity products on the low end of the product line without undercutting price levels for your differentiated products at the higher end.

There are five tactics for managing your participation in a reverse auction.

1. Preempt the auction: convince the buyer not to go forward with the auction because you have a unique value proposition and are not inclined to participate
2. Manage the process: influence bid specifications and vendor qualification criteria
3. Walk away: simply refuse to participate
4. Participate with a purpose: log-in and decline to bid; or bid once at current asking price to signal unwillingness to participate in an illegitimate auction
5. Participate with a focused strategy

The first factor to consider is the degree to which your product or services are differentiated from the competition. From the customer's perspective, one of the advantages of a reverse auction is that it focuses the purchase process around price while taking differential value off the table. If your offering provides significant value to customers relative to the competition, then you should focus on preempting the auction or influencing bid specifications in your favor.

A common tactic used by buyers to attain low bids during the auction is to publish broad offering specifications that enable the largest number of vendors to participate. As a result, suppliers with marginal quality are placed on the same playing field as top tier suppliers forcing the high quality vendors to discount heavily in order to win. Incumbents can often circumvent this process by influencing the offering specifications to exclude those marginal suppliers and create an auction with some integrity. This is a common situation faced by a Midwest recreational equipment manufacturer whose customers routinely use online auctions to create price competition with Chinese suppliers despite the fact that the Chinese makers have severe logistics limitations due to the distance from the U.S. market and lead time required for sourcing. To counter the sourcing tactic, the U.S. maker has frequently been able to bypass procurement and convince the operations group to specify tight lead times that make it difficult for the Chinese manufacturers to compete.

When there is no opportunity to influence the process or preempt the auction, you are left with two options: participate or walk away. Use extreme caution when considering whether to enter highly differentiated products and services into an auction because it undercuts your ability to get paid for your unique value.

If the auction is a heavy-handed attempt to gain unjustified price discounts, you can send a message to the customer by logging into the auction and bidding current prices or not bidding at all. This sends a clear indication that the only way they can gain access to the value of your offering is by engaging in a legitimate discussion about the value and an appropriate price. This was the approach used by a pharmaceutical manufacturer selling into Italian regional healthcare system. The manufacturer had a mix of unique and commodity products that it typically sold at an average 30% discount off list price. When the first regional organization switched to online auctions, the

manufacturer logged on and bid its normal 30% discount. Not surprisingly, it lost the auction. It was equally unsurprising when the healthcare group came back to the supplier asking for a 30% discount on the unique products offered by the manufacturer. The maker responded appropriately and refused to discount its unique products at all sending a clear message to the customer that aggressive procurement tactics will not induce the maker to give away its differential value.

When your offering is not highly differentiated from the competition, then fully participating in the auction may be your only choice. The first step toward successful participation is to understand the bid specifications. Never offer more than what the bid specifies, even if it is a regular part of your offering. If you win the auction, anything not part of the initial specification is subject to up-charges if the customer wants them. Understanding your cost to serve the account is essential because costing data will help determine your walk away price. Given that reverse auctions are often undertaken by large accounts looking to exploit their purchasing power, they often contain unique specifications that will incur incremental costs to meet. To avoid the risk of winning an unprofitable bid, care should be taken to estimate the true incremental cost of supplying the account including costs associated with special terms and conditions, specialized freight and shipping, dedicated supply arrangements and unique technical, marketing and sales support. If you find there is a long list of specialized requests in the bid, a viable option is to work to convince the account that you can provide lower prices if they work in a way that helps drive efficiency in delivering your products and services.

If you are not selected it is important to maintain the relationship in case the winner fails to deliver. A specialty chemical company did just that as they lost a reverse auction by a wide margin but decided to maintain an active sales presence with the customer. As they suspected, the new

provider had difficulty meeting the production and delivery requirements of the customer and supply availability was dampening the customer's sales. Because they were aware of the situation and worked to maintain contact with the account, they started to pick up large parts of the business at an elevated rate that reflected their ability to deliver.

Finally, it is important to remember that reverse auctions are a tactic used by price-buyers who are not interested in long-term relationships. Never try to win an auction at a loss in the hopes of getting your foot in the door to grow the relationship as this will rarely prove effective. Instead, set your walk away price and stick to it because winning an auction at an unprofitable price is a hollow victory. For many markets, reverse auctions have become a fact of life. Although there is no magic formula for winning the auction game, a well planned and carefully executed approach can help you limit price erosion and maintain profitability.

<sup>1</sup>Gartner Research Report (2003)

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