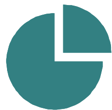

Valuing Vendors' Participation in Buying Groups: A Strategic Context for Contract Negotiation

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Introduction

Industrial buying groups enable independent distributors, dealers, retailers, and business-to-business buyers to collectively negotiate and buy products and services as a group, allowing individual members access to the sort of scale discounts that are traditionally available to only the largest individual buyers within a given marketplace. Designed and managed on behalf of their buyer members, buying groups typically measure their success in terms of purchasing scale—purchases made by members through pre-negotiated group contracts—and overall savings to members. As such, buying groups are driven to seek out highly competitive purchasing contracts with the largest and fastest-growing vendors in each of the primary sourcing categories defined by the membership.

To gain the attention of leading vendors, buying groups typically pledge the assurance of incremental or continued member purchase volume in exchange for a substantive price discount, often paid in the form of a rebate. Commercial and industrial sales managers are familiar with this type of trade off, since it represents the primary vendor sales strategy used in negotiations with national-scope channels and major customer accounts. But there is one key distinction: large account negotiations are direct, while buying group negotiations are indirect. Most buying groups don't actually buy products, and even fewer have the ability to compel their members to buy products from participating vendors. The indirect nature of the negotiation makes it difficult for vendors to truly assess the financial impact of participation.

Vendors must believe they will achieve higher overall operational profit than would presumably be achieved without participation in the group. To assess the overall business case, vendor resources must estimate the level of incremental operational profit that will be achieved, and/or the level of incumbent operational profit that will be protected from competitive encroachment. Figure 1 outlines the microeconomic problem faced by vendors negotiating with buying groups.

Figure 1: Impact of Vendor Buying Group Participation on Product Demand Within Membership (1a) and the Impact on Overall Vendor Profitability (1b)

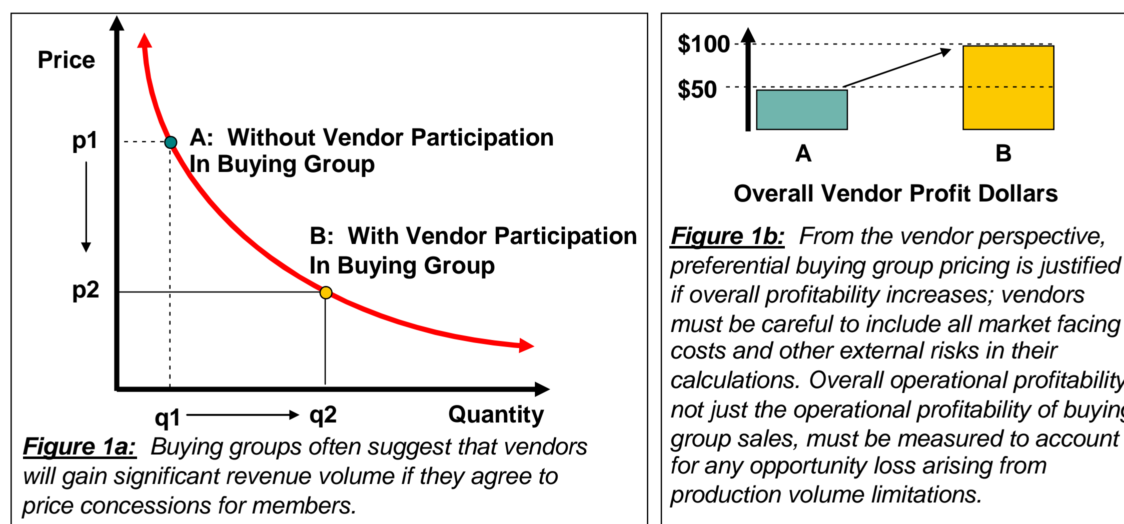


Figure 1a: *Buying groups often suggest that vendors will gain significant revenue volume if they agree to price concessions for members.*

Figure 1b: *From the vendor perspective, preferential buying group pricing is justified if overall profitability increases; vendors must be careful to include all market facing costs and other external risks in their calculations. Overall operational profitability, not just the operational profitability of buying group sales, must be measured to account for any opportunity loss arising from production volume limitations.*

Another important vendor consideration when assessing the financial dynamics of a buying group agreement is the calculation of the "moral hazard" inherent in the deal. This is the level of buying group discount that would subsequently apply to the vendor's incumbent business that would have been earned regardless of buying group participation. While some vendors have been able to exclude pre-existing deals from initial or new buying group agreements, such discussions become difficult or impossible to maintain during subsequent buying group negotiations. As such, it becomes a critical determinant of the vendor negotiation stance from the initial discussion.

In an ideal world, a buying group would be able to tell a prospective vendor three key facts to help establish their business case:

1. The level of category purchases made by members in the preceding year and the forecast growth rate for the coming year
2. The level of these purchases that were made using the buying group's contract
3. The percentage of these purchases that would switch to a new vendor, if a new vendor were to take over the existing buying group contract

The vendor would weigh this information, along with information pertaining to incumbent sales to buying group members, and incorporate these into a financial model. Unfortunately for vendors, all of this pre-negotiation due diligence is largely in their court. This is because relatively few buying groups collect and provide the sort of quantitative statistics that help vendors financially justify participation in their contracts.

A review of the "vendor / supplier" benefits offered by a number of leading buying groups reveals the decidedly qualitative justifications offered to prospective vendors:

- "We pledge to limit the number of endorsed suppliers in each product category"
- "We encourage our members to treat endorsed suppliers as incumbents"
- "Vendors can be assured of customer loyalty and ease of marketing"

The use of terms "pledge", "encourage", and "assure" are not exactly the stuff that finds its way into hard edged pro forma statements. Despite their lack of formal vendor justification, buying groups can offer vendors some compelling benefits—particularly to vendors without incumbent positions. It is the challenge of the vendor's sales and marketing team to define, quantify, and design an appropriate go-to-market strategy to harness this value.

Segmenting Buying Groups Based on Value to the Vendor

Based on Frank Lynn & Associates' experience evaluating buying groups in the industrial and commercial marketplace, the relative value of participation to a vendor can be best defined along two behavioral axes.

Axis One—Relative Brand Influence of Buying Group

The first axis is the relative degree of brand influence the buying group has over member purchases within a given product or service category. On one end of this spectrum are the "compulsory" buying groups that exist within the U.S. health care marketplace. These entities require their members to buy up to 90% of their purchases from participating vendors, and take steps to monitor and enforce this compulsory participation. Such organizations can command significant vendor price concessions due to the guaranteed nature of the sales volume and because contracts tend to be negotiated every three to five years. To strengthen their negotiating position, these compulsory groups document the level of purchases and the degree of member purchase compliance within each category. Compulsory buying groups exist in few industries outside of health care.

A majority of buying groups is on the other end of this spectrum—and offer members "voluntary" participation on vendor contracts. Members of these groups are encouraged to purchase from contracts negotiated by their buying group, but are still able to negotiate and source from vendors outside of the buying group context. Some even permit members to belong to more than one buying group. That said, the most organized of these groups prohibit multi-group membership and take active steps to encourage members to purchase from vendor contracts. This is done through traditional vendor "meet and greet" events as well as the establishment of individual member purchase level targets. Such programs offer members financial incentives for purchasing incremental volume from vendor contracts—leveraging funds that arise through stair-step rebates or discounts offered by participating vendors.

Axis Two—Number of Approved Vendors within the Product Category

The second axis relates to the number of vendors approved by the buying group within a given product or service category. On one side of the axis are buying groups that specify a single vendor within a majority of product and service categories—on the other side are groups that specify multiple vendors. For vendors, it is obvious which side of this axis provides greater value—a single vendor contract. But for buying groups, the decision matrix isn't quite as simple. In most cases, the competitive structure of the industry is what drives the overall number of vendors on a given buying group contract.

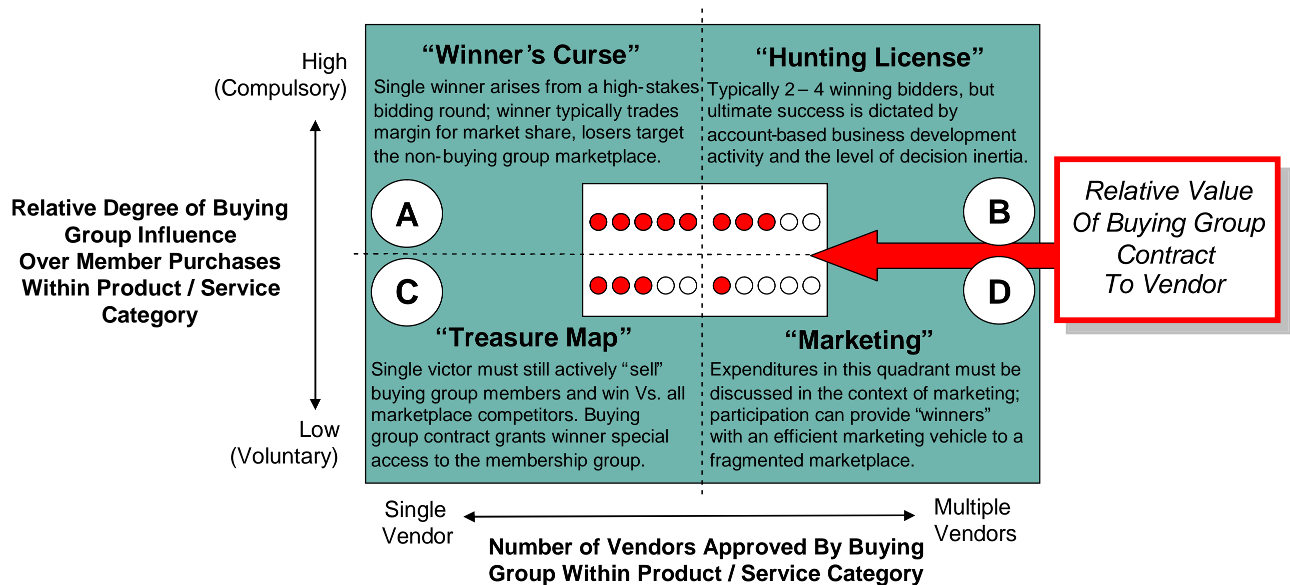
In highly competitive or commoditized industries, or where a single vendor represents a preponderance of industry production volume, buying groups can benefit from a "winner take all" single vendor approach. In such circumstances, members do not typically have difficulty accepting a single vendor—provided that the selected vendor's quality and reliability are at parity with the competition and meet expectations. Within these product categories, the strongest buying groups will contract with a single vendor for a three to five year "winner take all" agreements, and weaker groups will negotiate annual contracts.

In industries where product and end-user differentiation is a critical determinant of brand selection, buying group members are not willing to accept a single vendor. To satisfy member requests and gain a high percentage of category purchases, buying groups will typically contract with two to four vendors within a given category. With multiple vendors given access to member purchasing volume, participation in such contracts helps winning vendors isolate themselves from non-participants, but does nothing to guarantee purchase volume. As such, multi-vendor contracts offer a much weaker value proposition to vendors.

Combining the Axes to Reveal a Vendor-Oriented Market Map

When the two axes are combined, the resulting market map offers guidance to vendors regarding the potential value of a buying group agreement. While buying group value can exist across the entire spectrum of the two axes, four basic value positions emerge. Figure 2 below documents the intersection of the two primary value axes.

Figure 2: Buying Group Value Matrix—Vendor View



Quadrant A: Winner's Curse

The intersection between compulsory buying group behavior and single vendor selection, this quadrant offers the most compelling position to vendors—particularly from the perspective of revenue recognition. The title of the quadrant is especially fitting to any manufacturer or service provider who has managed to win one of these contracts. Fierce contract negotiations, often covering a three to five year time period, typically drive gross margins down to a level at which only the largest vendors can cope. Winners of contracts within this quadrant must be truly positioned as the lowest cost supplier in their industry or be prepared to use the contract volume to cover fixed costs and drive profitability from sales to other market sectors. Vendor negotiations within this quadrant are some of the fiercest in all of business-to-business marketing—leading to the extremely slim margins that lend credence to the quadrant name.

Quadrant B: Hunting License

The intersection between compulsory buying group behavior and multiple vendors selection, this quadrant limits market competition to two to four vendors. Such contracts are referred to as a "hunting licenses" since participation merely grants the winners the license to solicit buying group members for their business. Because contract participation alone does not guarantee any sales, winners are required to expend significant sales resources on top of the discounted buying group price in order to gain market share. When the winning bidders establish a fixed contract price, this price floor re-defines the competitive landscape, driving the winning vendors to define their value to buyers on non-price elements, such as order reliability, warranty factors, and other service-related terms. When the winning bidders do not pledge a specific price, but instead pledge a rebate on goods or services purchased within the context of the agreement, price negotiation remains a key determinant used by vendors to secure individual member business.

Quadrant C: Treasure Map

The intersection between voluntary buying group behavior and single vendor selection, the vendor benefit of being the sole winner of the contract is diluted by the fact that buying group members are at liberty to purchase products outside of the buying group contract, or even to participate in multiple buying groups. Buying group members tend to buy some categories of products or services through the selected buying group vendor and other categories through direct vendor negotiation. As such, the sales force of the winning vendor is granted a "treasure map" of the buying group membership that may or may not reveal incremental sales. Despite the drawbacks inherent in this quadrant, incumbent vendors with strong field sales forces can leverage contract participation to keep less-well prepared competitors at bay. This dynamic can be particularly powerful if the buying group is evolving toward a stronger, more compulsory model.

Quadrant D: Marketing
The weakest quadrant from a vendor perspective is the intersection between voluntary/ unmeasured buying group behavior and multiple vendors selection. Vendors in this quadrant must value contract participation from the perspective of go-to-market efficiency. Participation can gain a relatively unknown vendor an efficient and effective sales and marketing platform upon which to target a fragmented marketplace. It can also lend an unknown vendor significant credibility. But be forewarned—vendors who place a great deal of stock in the influence wielded by such buying groups will likely be underwhelmed by their level of member purchase influence.

Incorporating the Buying Group Value Matrix into Your Market Strategy
While buying groups, co-operatives, and related buyer-oriented consortia exist in some form in virtually every industry, the level of influence and power wielded by these groups varies significantly from market to market. Relevance tends to be highest in concentrating markets, driven by smaller players seeking a level playing field with industry titans. Regardless of the strategic relevance of the buying group within its industry or to its members, all buying groups position themselves to appear as relevant as possible to current and prospective vendors in order to gain vendor pricing concessions.

Prior to buying group negotiations, it is the vendor's responsibility to understand and define the strategic context in which to assess the value of the contract. Simply placing the buying group within one of the four matrix quadrants can yield significant insights into the relative importance of the negotiation. Further defining the effective degree of contract compliance and the extent to which such compliance is based on buyer inertia, incumbent brand preference, or simply vendor contract participation can provide vendors with a compelling view of buying groups' significance within the overall marketplace. The final step is the calculation of the "moral hazard" associated with paying incremental buying group discounts to members who would have purchased the vendor's products even without the buying group agreement. Vendor negotiators with a firm understanding of the costs and implications of competing with and without buying groups are the parties least likely to leave money "on the table" during their next buying group negotiation. Are you prepared?

How Frank Lynn & Associates Can Help Your Organization with This Issue

Key questions you should be asking:

- What percent of purchases in your industry are attributed to buying group participation, are buying groups growing in importance in your industry, and what is the relative revenue and margin that can be gained through participation in a buying group contract?
- What percent of buying group member purchases in your product category are attributed entirely to vendor participation in the buying group?
- What are the alternatives to participation in buying groups, and what are the inherent costs and risks of this strategy?
- What would be the impact to market share if your company—or your competitor—terminated its buying group contracts, and spent some or all of the residual savings on targeted market-facing activities?

Frank Lynn & Associates can help you answer these questions, assess the urgency of developing relationships with buying groups, establish which buying groups are most effective and relevant in your industry, and ultimately, assess how leveraging these relationships will impact your bottom line.

Contact Karl Edmunds at 312.55.4866 to schedule a confidential, complimentary one-hour discussion o how to best address this critical sales and marketing issue.