The Journal
Issue 02

THE ART OF THE REVERSE AUCTION

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The transformation of procurement from a humble back-office function to a front-line strategic weapon has had a dramatic impact on the buyer/seller landscape, changing it irrevocably.

In the battle to improve bottom-line cost savings, global organisations have made huge investments in equipping their procurement departments with advanced sourcing tools and processes.

Above all technological developments, the introduction of the reverse auction significantly strengthened their power in managing - and controlling - the sales process. Procurement departments have embraced this tool to varying degrees, but with the auction capability in the Fortune 500 approaching 100%[1], it is clearly a business practice that is here to stay.

However, selling organisations struggle to see the benefits of participation. The common perception is that reverse auctions commoditise their offering, destroy established relationships and focus single-mindedly on price. And who can be surprised with this mindset, when the vice president of supplier management in a Fortune 10 technology firm publicly observed: “There is no reason suppliers should like reverse auctions. It is a tool that is designed to transfer margins from them to me.”

Increasingly, no product or service seems exempt from the reach of the reverse auction. Having exhausted the easy opportunities in sourcing commodities, procurement managers are now reverse auctioning complex services and difficult supply markets. Indeed, after successfully auctioning a £350 million legal services contract, the procurement director of a leading financial firm stated: “If it can be invoiced, it can be reverse auctioned.”

In response, in the face of this onslaught, there has been no parallel development of a ‘best practice’ approach. Unsure how to respond, many selling organisations adopt a simple binary stance: follow the process or walk away. But with the average auction contract valued at $2.2 million[2], is bidding blind or refusing to play an effective strategy?

To develop a framework for operating in this new and more sophisticated procurement environment, Huthwaite International conducted a global study that determined the strategies used by leading selling organisations to successfully combat the impact of reverse auctions. It also identified five common traps that inexperienced sellers fall into.

One insight uncovered by the study is that incumbent suppliers greatly enhance their chances of success by not following procurement's rules slavishly. Rather than refusing to play, they simply treat the online event as a vehicle for submitting a 'best and final' offer.

In addition, contrary to common perception, the research showed that the "lowest bidder wins” rule was applied in less than 17% of auction events. Therefore securing the first place position will not guarantee success. But here lies the real issue: to maximise bidding competition, procurement has conditioned suppliers into believing they have to be the cheapest to win. Counter-intuitively, the research also found that there is no significant correlation between time spent preparing for an auction and success rates. Critically however, the average time spent planning a bidding strategy by successful bidders was 9.2 hours - three times that of their unsuccessful counterparts.

Finally, however good the planning, it’s important not to get caught up in the frenzy of a bidding war. The bottom line, both literally and metaphorically, is that no deal is better than a bad deal. Thus in reverse auctions, as elsewhere in life, the key to success is in knowing the rules and how to play the game.

To learn how successful selling organisations are planning for auctions or to organise an in-company presentation of the research, please contact your Huthwaite account manager.

You can also contact Huthwaite's consultant, Andrew Moorhouse, who conducted the research on: + 44 (0) 1709 521 213 or amoorhouse@huthwaite.co.uk

[1] Source: Aberdeen Research (2007).
[2] Source: Center For Advanced Purchasing Studies (2007).