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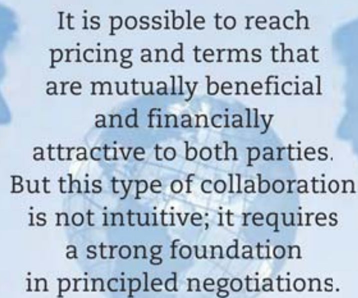

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Mistakes to Avoid When Negotiating with Suppliers

By Brad Birdwell

It can be challenging to assess the quality of pricing and terms for contracts and purchases that require the approval of the financial executive. When considering "Did we get a good deal?" the answer is invariably "Yes." The follow-up question, "How do we know?" often gets a less certain reply.

Employees at all levels of a company's business units strive to be good stewards of its resources, but are rarely hired for their expertise in vendor negotia-

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tions. And few in the C-suite get involved in all but the most strategic vendor deals.

Fundamentally, a good deal includes transparency into vendor pricing practices. With profit maximization the primary responsibility of the sales team, establishing strong agreements requires an understanding of the tools used by suppliers to increase margins.

When handled correctly, it is possible to reach pricing and terms that are mutually beneficial and financially attractive to both parties. But this type of collaboration is not intuitive; it requires a strong foundation in principled negotiations.

Does the deal favor the vendor or purchaser? There are five warning signs a deal might be better for the vendor's bottom line than for the purchaser:

1 The Team Requested a 'Budgetary Quote'

Before any negotiations begin, managers often call on vendors for "something to put in the budget." The project is not yet approved, and the pricing from the vendor will not be heavily discounted at this time. As soon as that phone call occurs, significant leverage has been lost.

The vendor has established a starting point for the negotiation, and will believe it knows how much the purchaser has budgeted. Even if the deal is subsequently sent for other bids, expectations for what a good deal looks like may be based on the original quote.

The mistake is even more costly if the vendor is a reseller, as it will likely "register the deal" with the manufacturer. This locks in the vendor's right to special discounts to which other resellers will not subsequently have access, allowing the reseller to build additional margin into the price while still providing a discount that its competitors cannot match.

This is not to say a purchase team should never contact suppliers for budget information, but it should be avoided when possible and handled carefully when necessary. Ideally, budgetary numbers should be based off of third-party benchmarks. Even if benchmarks are unavailable, consider using a published list price instead of asking for a quote from a vendor.

Early quotes are effectively the start of a negotiation, and the team is negotiating from a position of weakness due to the accelerated nature of the talks, the unapproved state of the project and a lack of clearly defined competitive alternatives. The vendor's sales organization will kick into gear as soon as a company reaches out, and will begin looking for opportunities to move toward a deal.

If using a vendor quote as part of the evaluation of a project, it's wise to establish the following ground rules:

- If the vendor is a reseller, the purchaser should let it know that it does not have approval to register the deal, and will avoid doing business with the vendor if it does so.
- Set expectations that quotes will not be viewed as relevant to any subsequent pricing negotiation.
- Let the vendor know other budgetary quotes for competitive solutions are being obtained from other suppliers, with the same ground rules.

2 The Proposal Included Bundled Pricing

There is margin in the mystery of bundled pricing. It is difficult to establish a good deal without transparency into the cost of each product and service included in the set. Instead, expect line-item pricing, even while negotiating based on the total expense.

Among other benefits, the approach allows the benchmarking of individual components and determines whether certain items would be more effectively procured from alternate vendors.

Additionally, usage-based pricing or volume-based discounts can be established for variable volumes, particularly if the company has control over that usage. This can allow recognition of the benefits of future usage optimization.

Lastly, separating costs will make it easier to align the contract to future changes in the business. At a later date, the purchaser may want to replace or remove individual items from the agreement, and bundled pricing will make it difficult to get fair value for the removed items.

With discrete line items, it's possible to ensure optimal pricing, better align to the go-forward needs and control the cost of potential growth. Without this transparency, volume discounts or rebates are instead tied to the total dollar value of the deal, preventing optimization of any one area of growing spend.

3 The Price Was Discounted From 'List Price'

Discounts are not meaningful unless the starting price was already reasonable. Whenever possible, pricing should be on a cost-plus basis, tied to the underlying expenses of the vendor, or the commodities that drive the cost. At a minimum, negotiation should be tied to objective criteria and a clearly defined BATNA (Best Alternative to a Negotiated Agreement).

Faced with benchmarks and a clear business case for alternative solutions, the obligation shifts to the vendor to build pricing from the ground up, rather than from the top down.

Long-term agreements with catalog-based product pricing are particularly risky. Suppliers know which products have an underlying cost that is likely to decrease over time as well as to improve as a result of additional volumes. When there are variable delivery costs, beware of fixed rates that are "best in class" at the time of implementation, but cannot be adjusted based on changing market benchmarks.

A well-defined contract will remain competitive throughout the

term, rather than becoming egregious over the course of the deal.

Finally, the purchase needs to be careful not to focus too much on a particular product or service during the negotiation. Suppliers frequently offset competitively priced items with much higher margins on ancillary products and services or changes to standard configurations. As a result, higher margin items may become a greater percentage of the spend if the product mix changes over time.

4 The Negotiation Was With The Account Manager

Account managers typically have limited authority beyond flat-pricing discounts. Creative negotiations that align the contract to the correct pricing model usually require direct discussions with the executive decision-makers within the supplier's organization. Otherwise, it's a matter of relying on the sales representative to articulate the message to the vendor management team and — much like the game of "telephone" — the message may be lost in translation.

Similarly, the supplier often doubts whether its own delegated sales representative has effectively represented its position. In some cases, the supplier authority may even be hesitant to support the account manager's assessment of a particular requirement, viewing the account manager as biased because his or her compensation is dependent on closing the deal.

Prior to any bargaining, there should be a "meta-negotiation" wherein the roles of the negotiation are agreed upon in advance. The supplier's negotiating team must have the authority to commit to unique pricing and terms without escalating the proposal within their company.

The primary role of the account manager should be to educate the purchaser's team on products and services and to facilitate discussions with the purchaser's management. The vendor account manager thus serves as an advocate, partnering with the purchaser to help "sell" the value of the deal to its management team.

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5 The Contract Includes 'Standard' Terms and Conditions

A good deal today may be a bad deal tomorrow. Suppliers are negotiating based on the long-term value of the deal, and many contract terms are designed to improve vendor margins over time. Exclusivity agreements — which limit the purchaser's ability to bring in secondary suppliers — can ensure higher margins for the supplier if the business grows.

Conversely, volume commitments will drive higher margins for the supplier if the business slows or usage is reduced. Such minimum commitments are the Achilles heel of many agreements, and are often not changed even during a renegotiation.

It is not uncommon for a supplier to drop its per-unit cost while failing to implement a corresponding drop in the annual commitment. As such, the write-down may become "sleeves off the vest," creating only the perception of savings.

Many agreements have auto-renewals or evergreen provisions, often in conjunction with pre-negotiated price increases. Such contracts may require significant notice of any intent not to renew, which greatly reduces purchaser negotiating leverage if the deadline passes.

On the other hand, vendors that provide complex services may take an inverse approach; they will recognize that there are significant costs and time associated with switching suppliers and will thus strive to push negotiations as close to contract renewal as possible.

In such situations, by time the bargaining begins, the purchaser will have limited its ability to identify competitive alternatives, create a hypothetical plan for switching or otherwise develop a compelling financial case to provide leverage during the negotiation.

Lastly, be careful when establishing service level agreements (SLAs), which often lack financial penalties or inadequately align to a purchaser's own customer obligations. Requesting SLAs with penalties that are non-standard for the vendor may include significantly increased pricing so as to mitigate the vendor's own financial risk.

If any of the situations described above are recognizable, it is likely a company is overpaying for products and services. Such risks can be mitigated by a mature strategic sourcing organization, or by engaging third-party expertise to support enterprise negotiations.

Undoubtedly a company's managers and employees are held accountable for the quality of the deals they negotiate with suppliers.

Keep in mind that the folks on the other side of the table are doing the same and in the case of the vendor's sales staff, it is the primary role they were hired to fulfill.

The executives within the supplier company will not be asking the purchaser's account manager," Did we get a good deal?" They already know the answer. By keeping an eye out for these common pitfalls, readers will know the answer, too.

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