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Portfolio Company Performance sm

Quantifying Buyer Power

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Consider the following challenges in price management in B2B environments:

- **Price elasticity** – Elasticity for products sold by B2B vendors is difficult to measure because the demand is ultimately derived from the consumer market. So, even in the best case where there is a B2B vendor who sells directly to a B2C vendor, the demand curve and elasticity are derived from the B2C vendor's demand curve and elasticity. For B2B vendors who are further away from the consumer, the task is nearly intractable.
- **Statistical analysis** – Most B2B vendors have hundreds or thousands of customers and prospects. By contract, many B2C vendors have several thousand to several million customers and prospects. In the B2B scenario, one can't do statistically significant analyses because there are not enough customers and prospects.
- **In-market testing** – B2C vendors routinely run in-market tests at a subset of stores or locations to estimate price response. Based on the response, they may decide to apply the price to a broader set of stores or geographies. Like the challenge for statistical analysis, B2B vendors have a much smaller base of customers and prospects. Running in-market tests is not only inconclusive, but risky to the customer base.
- **Buyer Information** – Corporate buyers have become more sophisticated over time. These buyers may know the COGS of the seller and its competitors to very fine levels. Still worse, based on dialog in close-knit industries, the buyer may know the price of the seller's most recent deal with another buyer. In some cases, e.g. competitive bids, the buyer has nearly perfect information about the seller's and its competitors' products, prices, and costs.

Given these challenges, in a negotiated transaction, how is a seller to accurately comprehend how much power the buyer has? Without this understanding, the seller has little assurance that he is not leaving money on the table. The problem we address is how to understand and how to reduce the buying power of customers. The approach that we have developed at Z2M4 is to quantify how much buying power a customer has with respect to a particular product from a particular seller. Once the seller understands how much buying power the customer has, he can decide whether and how much to discount from list price. This approach allows sellers to routinely capture at least 1% more in price/margin which, in turn, drops directly to the seller's bottom line.

Buyer Power Analysis

The concept of Buyer Power was developed by Michael Porter at Harvard Business School for competitive strategy along two dimensions:

- **Price sensitivity** – how much does a buyer care about price? There are a number of factors that we use to quantify price sensitivity including the value of the seller's offering measured as TCO or ROI, the profitability of the buyer, the strength of the seller's brand, and the size of the purchase.
- **Bargaining leverage** – what can the buyer do about it? We quantify bargaining leverage based on the size of the transaction, presence of substitute products, buyer switching costs, ability of the buyer to make the product themselves, buyer information, and the level of competition in the industry.

This distinction between price sensitivity and bargaining leverage is useful in assessing how much power a buyer has because they really are independent dimensions – customers with high price sensitivity may not have much bargaining leverage and vice versa. The combination of price sensitivity and bargaining leverage determines the total buying power.

Buyer Power Details

In the Buyer Power Detail table, there are five accounts that have been scored for bargaining leverage and price sensitivity. Smaller scores are more favorable to the seller. From this example, one can see that Account #3 has the least buying power and Account #5 has the most buying power of the five accounts. The detail scores for each account are shown as well. These details can be used to the seller's advantage during negotiation. For example, with Account #1, the buyer switching cost, buyer information, and ability to backward integrate are all seller favorable. The main bargaining leverage issues for the seller are the size of the deal and the propensity of the buyer to use substitute products.

Account	Bargaining Leverage Score	Price Sensitivity Score	Bargaining Leverage	Buyer concentration vs. firm concentration	Buyer volume	Buyer switching costs	Buyer information	Ability to backward integrate	Substitute products	Price Sensitivity	Price/total purchases	Product differences	Brand identity	Impact on quality/performance	Financial health
Account #1	3.7	6.9		4.00	9.85	0.00	2.50	0.00	6.20		1.12	5.00	5.00	7.63	10.00
Account #2	6.5	1.5		2.34	10.00	5.00	10.00	10.00	0.00		0.83	0.00	5.00	4.00	0.00
Account #3	2.7	1.6		2.34	6.20	3.50	2.50	0.00	0.00		0.40	0.00	5.00	4.20	0.00
Account #4	4.1	5.5		2.34	4.69	6.25	2.50	0.00	6.75		0.03	10.00	5.00	8.38	0.85
Account #5	7.4	6.8		5.00	10.00	2.25	10.00	10.00	8.75		0.60	5.00	5.00	7.50	10.00

Seller Favorable
Seller Neutral
Seller Unfavorable

Table 1 - Buyer Power Detail

Buyer Power Zones

The bargaining leverage and price sensitivity scores are plotted (in inverse order) for these five accounts in the Account Buyer Power graph below. The graph shows the accounts as being part of different buyer power zones including skim, value, price, and avoid. (The size of the bubbles represents the account value to the seller.) Accounts in the skim zone have the least price sensitivity and bargaining leverage. These accounts will buy at or near list price. Accounts in the value zone are still seller favorable overall, but have some combination of sensitivity or leverage that the seller must take into account in the price negotiation. These accounts will likely require some discount or promotion to acquire the business. Accounts in the price zone may still be good accounts, however, the combined sensitivity and leverage is now buyer favorable. These accounts may require significant discounting to acquire the business. Accounts in the avoid zone have extreme buying power and have poor likelihood of being profitable for the seller.

There are two areas that can be adjusted in the process of negotiation: price and value. Given that Account #3 is in the skim zone, the seller can nearly maintain list price and not offer additional value. By contrast, Account #5 is in the price zone. The seller may need to lower price and to offer more value in the form of support, training etc. to attain or retain Account #5. Given the value of Account #5, this move is justifiable.

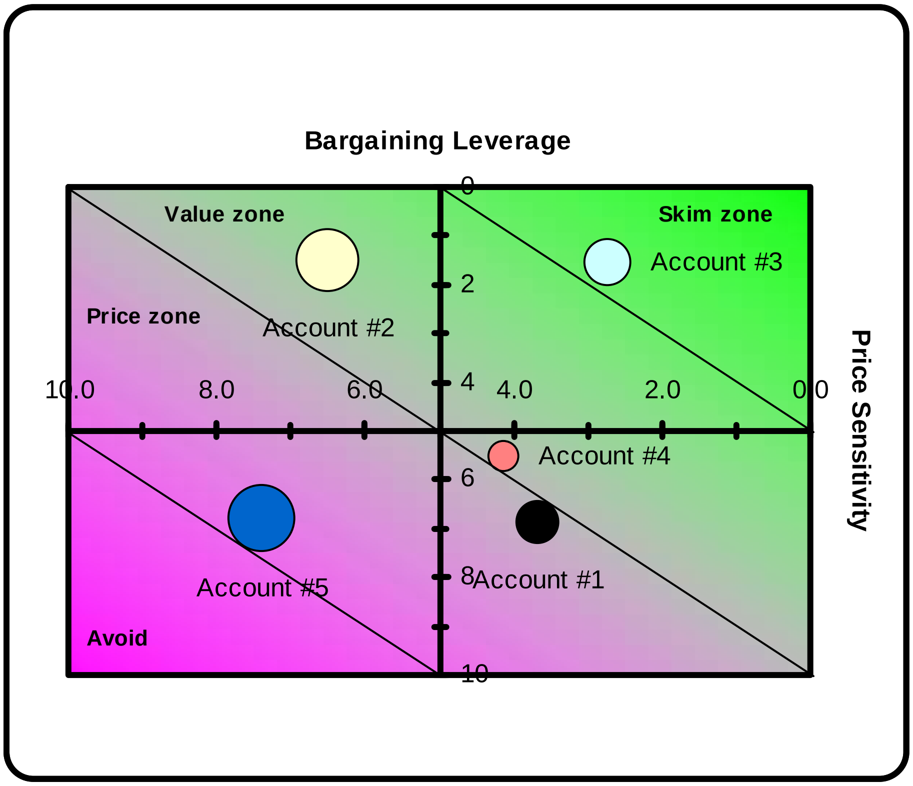

Figure 1 - Account Buyer Power

To summarize, the process of buyer power modeling allows a seller to understand how much price sensitivity and bargaining leverage a buyer has. Based on this understanding, a seller can make appropriate and precise decisions about discounting and promotions. The net effect is take back much of the power that the buyer has in negotiations. Z2M4 has applied this approach recently with its clients to help them achieve price improvement above 1%.

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